S. Hrg. 99-1096

THE TAX REFORM ACT OF 1986: IMPLICATIONS FOR THE FUTURE

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

SECOND SESSION

SEPTEMBER 12 AND 15, 1986

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
76-625 WASHINGTON : 1987

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

J841-33

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THE TAX REFORM ACT OF 1986: IMPLICATIONS FOR THE FUTURE

FRIDAY, SEPTEMBER 12, 1986

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey, Hamilton, Scheuer, Wylie, Fiedler, Kaptur, and Archer.

Also present: Stephen Quick, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative Obey. Today the Joint Economic Committee is holding the first of 2 days of hearings on the probable effects which the conference agreement on the new tax bill is likely to have on the economy.

I think it is fair to say that the conference report appears to be working its way toward a vote on deliberate speed. Any member who is not a member of the conference committee frankly has very little to go on by way of specific legislative language.

My understanding is that we may be asked to vote on it after we have that language for as short a period of time as 2 days. Having on several previous occasions been required to vote on legislation without having copies of it, I have a quaint idea that it would be helpful if we had a greater understanding of what is in the bill before we vote on it.

I am approaching these hearings with a totally open mind. Frankly, I have expected that in the end I would probably support whatever legislation came out of the conference because I think that we have assumed that legislation will make the system more efficient, more just and more equitable.

But before actually committing ourselves, and I have no doubt that the bill is probably going to pass, and I think that is almost a foregone conclusion, but I think before we actually vote it would be good to know the answer to a number of questions that we will have to face after the bill is passed.

Specifically, there are four broad areas of concern I think we would be wise to address before we actually vote and go home to our constituents and explain exactly what it is we have done.

First, I think we would like to have as good an idea as possible about how this bill will affect the deficit. As we all know, Gramm-

Rudman put severe limits on Federal fiscal policy. Were revenues to drop significantly, for instance, Gramm-Rudman does not allow that to happen without making corresponding reductions on the spending side.

So while I certainly recognize, and I think every member of the committee does, the difficulty that anyone has in estimating future revenues, and we certainly do not expect perfect accuracy, I think we need to have some assessment of how reliable those revenue estimates are and whether the errors in revenue estimating are likely to be on the high side or the low side and where that is likely to put us in terms of future policy action that would be required.

Second, we need to explore what the effect of this bill is likely to be on the trade deficit and on the competitiveness of American industry. Some have argued that repeal of the investment tax credit and the imposition of a corporate minimum tax would raise the cost of capital and depress investment, particularly in the heavy manufacturing sector and that the result might be that in a few years we would be buying more foreign goods and fewer American-made goods.

Others argue that the lower marginal corporate rates and the elimination of other distortions of tax shelters would increase the efficiency of the tax structure, increase the rationality of investments and make a positive contribution to competitiveness. I think we ought to take a further look at that.

Third is the question of the rate structure of this bill. Is it in fact superior to the current rate structure and is it defensible? The bill lowers the marginal rate for the richest taxpayers to 28 percent, but it has an effective 33 percent marginal rate for the next lowest grouping of taxpayers, the well known—well, probably not so well-known hump that is now in those tax rates.

The bill is still being described in most quarters as a two-bracket bill, but it is not in fact a two-bracket bill in terms of its marginal tax rate effect on taxpayers and we need to discuss whether it is good enough to justify support.

Finally, I think we have to ask, and this is probably the most important question because maybe we don't know the answer to any of the other questions, but there are always unintended consequences from actions that you take. And it would seem to me that we ought to try to explore what kinds of changes in the Tax Code people will be asking us to make in 1987 and 1988 if we pass this conference agreement this year.

In other words, it this is the first shoe, what is the second shoe that is likely to be dropped, and what kind of arguments are likely to be made in the coming months after passage of this legislation concerning problems that are either created or not addressed by this legislation. I think we ought to explore how well the Congress and the Tax Code will be positioned to respond to those arguments and those pressures. In short, what I am really asking is what, if anything, are we setting ourselves up for in terms of future pressures for change in the Tax Code that will most surely come no matter what kind of legislation the Congress would pass.

These are the kind of questions which I think we ought to explore and they certainly are nonideological and they are certainly I think questions in the minds of many Members of Congress who I have talked to on both sides of the aisle.

I would approach the vote on this legislation with some additional comfort if I knew more about the answers to those questions than I think most Members of Congress, including yours truly, know right now.

Congressman Wylie, do you have any comments you would like to make before we begin?

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative **Wylie**. Just a brief comment. Thank you very much, Mr. Chairman, and I congratulate you for this very timely hearing and for putting together this very distinguished and knowledgeable panel.

I do want to welcome them here this morning and would say that I would like to know the impact of the tax conference report bill on our economy, too, and what effect it might have had on the decline in the stock market yesterday. I have been asked that question already this morning.

Representative **Obey**. I thought that was just you taking profits. [Laughter.]

Representative **Wylie**. No, I wasn't one of those. [Laughter.]

But as you know, the President is for it, and the President knows how to put on a full-core press when he is for something. So I have been predicting that we will probably have a tax bill before this session ends.

I might say that during the district work period, Mr. Chairman and members of the panel, I went around and talked to many groups and wanted to feel the pulse of how my constituency felt about tax reform.

So I would take a show of hands and I would have to say that I think somewhere in the neighborhood of 70 to 75 percent said I think on a yes or no vote you should vote for the package and then we would get into the areas where there were some trouble or there would be some trouble with the tax package, some real estate people and home builders and apartment owners especially don't particularly like it.

So I think it is timely, as I said, and I would like to have you address those issues. If you don't in your opening remarks, I will get into some questions on those. But I certainly am very anxious to hear from you this morning to try to add to what little expertise I have about the tax bill. Thank you very much, Mr. Chairman.

Representative **Obey**. Thank you, Congressman Wylie. Why don't we begin. Let me simply read the names of——

Representative **Scheuer**. Can I say something?

Representative **Obey**. Sure.

OPENING STATEMENT OF REPRESENTATIVE SCHEUER

Representative **Scheuer**. I am Congressman Scheuer, and I am a Democratic member of the Joint Economic Committee. I am delighted that we are having this hearing and I congratulate our chairman for calling it.

There are two questions that I hope you will address yourselves to as you talk to us about the public policy questions undergirding this tax reform measure.

First of all, it seems to me that the intellectual underpinning of this bill is that it should be revenue neutral and the intellectual underpinning of that assumption is that the budget deficit really doesn't matter.

I would like you to tell us whether it does matter and maybe we can get along and just continue borrowing every year as the deficit grows by $10 or $15 billion a year and maybe that is a healthy way for our economy to proceed. Please tell us if that is true, and if it isn't true, tell us what the alternative public policy options are for us.

It may be a difficult mission to push upon you, but we would like to know what are the public policy options to pursue if we want to eat into that budget deficit and finally get control of our financial and fiscal existence.

The second thing that I would like you to address, if you would be kind enough to, would be are we doing enough to encourage investment in our industrial and high tech sector?

I am very pleased that this tax bill does eliminate the egregious and totally irrational incentive to invest in real estate, in office buildings, high-rise apartments, shopping centers, and hotels that are not competitive with anybody overseas and that we can get along very well without.

How do we get the kind of incentive level that will encourage people to invest in the industrial sector so that we have a modern, up-to-date, cost-effective industrial sector that will enable us to compete in the bitter, tough, urgent competition around the globe, in which we have to fare as a successful competitor, if we are not to see our standard of living constantly eroding and in a constant state of decline.

Those are two questions that I hope you will address. Thank you very much, Mr. Chairman.

Representative **Obey**. Thank you. Now let me introduce the panel. Mr. Harvey Galper, senior fellow, Brookings Institution; Mr. John Makin, director of fiscal policy studies, American Enterprise Institute; Mr. Robert McIntyre, director of Federal tax policy, Citizens for Tax Justice; Mr. Lawrence Chimerine, chairman and chief economist, Chase Econometrics; and Mr. Joseph Minarik, senior research associate, Urban Institute.

Gentlemen, you each have indicated elsewhere some of your views, concerns, and reasons for support or reasons for caution. Why don't you proceed to tell us what you want to tell us. Mr. Galper, why don't you go first.

Mr. **Galper**. How much time in the initial go-around?

Representative **Obey**. Well, why don't you take at least—I don't want to squeeze any witness because what you have to say is a lot more important than what we have to say. So why don't each of you take about 10 minutes or so and if it is intolerable I am not going to sweat the time.

STATEMENT OF HARVEY GALPER, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. Galper. I will start off with a rather general set of points and then in the questioning and later discussion I hope to address more specifically some of the questions that you have put before us. They are good questions and they are difficult questions.

I will start off by saying that I think the Tax Reform Act for 1986, H.R. 3838, is good legislation and sound tax policy and does indeed merit your support.

The reason why it merits your support, in my view, is that the many good points outweigh some of the bad points. It is always a balancing act. The good points are several.

Just to hit the highlights, low income taxpayers are taken off the rolls by the increase in tax-free levels of income. We have lower marginal tax rates across the board which makes the tax system less intrusive and makes business planning more market oriented and less determined by tax incentives or tax preferences. This really is the best of supply-side economics.

The act improves horizontal equity in that all income is taxed more uniformly and there are fewer distinctions among taxpayers with respect to their sources of income, and I think that is probably one of the most important components of equity, that we are not distinguishing among equally situated taxpayers according to the type of income that they receive as we do to a substantial degree under current law.

Also, we have not changed the effective progressivity of the tax. We can debate whether the tax system should be more or less progressive, but we really haven't changed it very much. In fact, if you add the corporate tax receipts in as taxes that are really paid by owners of capital, then we in many respects may have made the system more progressive.

We are taxing investments more evenly and neutrally by eliminating tax shelters and by taxing capital gains in full, and we will as a result realize some gains in economic efficiency, not huge, but I think important gains.

It is not difficult, however, to find objectionable provisions in any bill as comprehensive as this. But in my view the appropriate perspective should be an overall assessment. The general objective of a broad-based, low-rate tax structure is much to be desired.

The specific ways in which the base has been broadened and tax rates have been cut in H.R. 3838 may not command universal assent, but by and large they are laudable.

I can quibble about some items. Capital gains in a pure world should be indexed, and we should tax only the real gain if we are going to tax gains in full. We may indeed have some transition problems. Also, we have not taxed fringe benefits. That is the purist approach, but it may be very hard to do.

We haven't tried to integrate corporate and individual taxes the way Treasury originally proposed with a 50 percent dividend deduction. The maximum tax is going to be very complex for corporations.

We do have this unusual marginal tax rate structure that the chairman referred to. Although it still is true that we have maintained overall progressivity and have still lowered marginal tax rates across the board, we haven't done this in a particularly esthetically pleasing way, I will acknowledge.

But I think we have to look at this package as a whole, and from my point of view it is a very desirable piece of legislation.

My next point is that it is now time to cease continually messing around with structural tax reform. The economy as well as the political process needs a period of respite from tax change. The basic structure of individual and corporate income taxation, as H.R. 3838 would establish it, should be maintained for at least 5 years.

This is not to deny that there may be unresolved tax issues requiring attention in the future. In my view these issues in order of importance are, first, the tax system simply does not generate sufficient revenues to finance the public expenditures we wish to make as a nation. We have a big deficit and may generate even larger shortfalls after the enactment of H.R. 3838.

I would say that is not a definite statement, but that is a possibility. Despite the best efforts, it is very difficult with legislation as comprehensive as this to pin down specifically what the revenue consequences will be when so many provisions of the Tax Code are changed simultaneously.

How will people respond to the minimum tax? Will that generate the revenues that we anticipate? What about capital gains realizations? What about passive losses and are there ways around that? We don't know. We can speculate, and the speculation will be that people will try to find ways of getting out from under these things.

Now that is again not to say that this is bad legislation. It is just to say that we should be sensitive to the fact that there may be a need for additional revenues down the road from this point of view as well as a definite need, in my opinion, from the point of view of the deficit.

Also, the economy may not perform as robustly as we would like, and we may require, therefore, some adjustments in fiscal as well as monetary policy. There may be, as the Chairman said, unintended effects, not just for the tax legislation, but the economy may move in ways which will certainly create demands for tax changes.

Investment already looks flat or declining. Will that precipitate, and we know it will, demands for reinstatement of the investment tax credit? Inflation may pick up, and will that precipitate demands for a further capital gains exclusion or for some other form of investment incentive such as accelerated depreciation?

In my view, if we do have those circumstances, we should react in a way which I think moves in the direction, as does this bill, of more accurate income measurement in a period of inflation. That is, we should index capital gains and we should index depreciation. That would be a rational response rather than going back to the ad hoc and inconsistent measures which adorn our current Tax Code.

Indeed, some provisions in H.R. 3838 may prove unworkable and require modification, but I believe that all these issues should be resolved in the context of the new reformed Tax Code.

That is, if we need additional revenues we should not introduce new revenue sources such as a value added tax, but indeed should look to ways of increasing revenues within the current tax structure. This would mean broadening the base in ways that perhaps we were not able to do initially but which still remain appropriate ways of raising revenues if it could be accomplished politically, such as taxing a portion of fringe benefits above some minimal level and taxing social security benefits more fully than we do now. These are all very exciting prospects I am sure.

There is also the possibility of increasing excise taxes without introducing a new value added tax, such as cigarette and alcohol taxes and gas taxes. In a book published last spring, "Economic Choices 1987," the Brookings Institution came out with several recommendations for ways of raising additional revenues without embarking upon a whole new revenue source such as a value added tax.

Excise taxes, as I say, could be made to raise $8 to $12 billion a year. Broadening the tax base in the way that I have mentioned could raise another $5 to $8 billion a year, and if we had to increase rates, we could increase rates on the new broader base, lower rate system to start with.

Just as a hypothetical example, 2 additional points in individual rates, moving the rate structure to 17 and 30, to illustrate the numbers involved, would raise by fiscal 1989 between $40 and $42 billion per year, not over a 5-year period.

Nobody wants to pay higher taxes, but it is clear that when you do have a broader base, lower rate system, the potential exists for using that system to generate additional revenues to close the deficit.

So my bottom line here is that the issues we have to face can be resolved in the context of this new tax structure which starts from a broader base and lower rates. If we have to raise tax rates as a last resort, the resulting rates would still be substantially lower on the margin than current law.

Let me stop at this point and respond to questions or proceed to other panelists.

Representative **Obey**. Thank you. Mr. Makin, please proceed.

STATEMENT OF JOHN H. MAKIN, DIRECTOR OF FISCAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. **Makin**. Thank you, Mr. Chairman. I want to try to concentrate a little bit on some specific aspects of the bill. I think Harvey has given a very good overview of what we might expect from it.

I would like to make four points about the bill and elaborate on them a little bit.

The first point I wanted to make in light of the discussion of the bill's possible impact and perhaps in light of the action in the markets these days is that in my view it will not precipitate a recession.

I think it will be blamed for everything from bunions to recessions that occur after it is passed, and I think it probably will be passed, but I think that is a bum rap and I will elaborate on that later.

I agree with the assessment that it is not an ideal income tax reform. It bypasses a number of major base broadeners, including owner-occupied housing and State and local taxes. So the degree of rate lowering and base broadening is somewhat constrained.

The studies that we have done at AEI suggest that it is about half way toward an ideal income tax system, and I think that is very good progress and I think it is worth enacting.

Our estimates, crude as they are, I could put them in perspective by saying that if you look at it in terms of a family with assets of $10,000, it would be the equivalent of that family moving to $10,100. In other words, the wealth or the total value of the gains is about 1 percent of national wealth. So it is not going to change your life type thing.

It is probably worth doing in the sense that you are doing the same thing differently. You are collecting approximately the same amount of revenue in a different way and thereby getting some gains. That is what I guess we mean by efficiency.

In terms of major strengths and weaknesses, I think the major strengths are again the increased incentives for economically motivated decisions rather than tax motivated decisions. These are widely cited.

Another one that is less widely noted, and that is it provides incentives to reduce the buildup of debt in the private sector, and I will say more about that when I broaden my comments.

The major weaknesses of the bill, and Harvey called it quibbling. I guess I would go further. I am very concerned about the lack of indexing provisions with regard to depreciation and capital gains.

The reason that I am concerned is really related to the bill's fragility. If we should get more inflation, then the types of gains that we estimate that come from the bill would disappear quickly because of the negative effects on investors of the perspective uncertainty of what they are going to earn on an investment.

To take an example. The bill's provision that taxes capital gains as ordinary income doesn't worry me as much as the fact that the gains aren't indexed. That means if you buy a stock, your after-tax return on the stock depends on what your forecast about inflation is because you are going to be taxed on the inflation gains.

So if you are very certain that inflation will continue at 4 percent for the rest of the century, don't worry about indexing. Otherwise you might want to index.

Also, while I think of it here, there is a gross misperception about indexing in the Tax Code. Sometimes when you bring up indexing people say well, that encourages inflation. That is absolutely wrong.

Indexing wages can encourage inflation by creating a wage-price spiral. Indexing the Tax Code to make sure that you don't tax illusory capital gains is not going to encourage inflation, it is going to encourage investment. We use the same word, but it is in a very different context.

Well, let me go back and elaborate a little bit on each of the points.

First, will it precipitate a recession? My answer is no. Why? The bill's provisions taken together, if you assume that interest rates are unchanged, would raise the cost of capital somewhere between 5 and 10 percent.

In my view, the bill through two means, one, its limitation of household borrowing and, second, the lower tax rates per se, will slow debt buildup. In a word, it is less attractive to borrow if the top tax rate is 28 or 33 percent than if it is 50 percent.

Let me bring it home to you in a way that probably all of us can understand. Think about those mortgage payments. Whatever they are, the after-tax cost of carrying your mortgage is going to be higher as tax rates go down, which is another way of saying that it is going to be less attractive to borrow.

This has already been noted. There was an interesting article in the Wall Street Journal last month which said that some financial counselors are saying you ought to pay down debt, that is, less borrowing by the private sector.

The same thing is true of corporations. Uncle Sam's subsidy for borrowing goes from 46 cents on the dollar to 34 cents on the dollar for most corporations. So there is an incentive for corporations to shift from borrowing to issuing stock or to shift from debt to equity finance.

I think the slower the debt buildup in the private sector, the less damaging are the large budget deficits which of course are debt buildup in the public sector.

Last, treating capital gains as ordinary income, if inflation doesn't cause serious problems, simplifies the Tax Code a great deal and does away with the shenanigans undertaken to attempt to translate ordinary income into capital gains.

So I think there is some simplification in the Tax Code in that area. I am not prepared to argue that this is a major simplification effort, but it does cut down on the incentive for shenanigans.

Another important thing that we will see if the conference agreement becomes law is that it cuts down on the incentive for corporations to retain cash. By that I mean oftentimes how corporations rather than paying dividends to their shareholders retain cash and say well we are just going to hang onto the cash and the shares will go up in value and you will get capital gains.

Now if you have that situation with lazy and unimaginative management, and I am sure there are very few such managements——

[Laughter.]

Mr. **Makin** [continuing]. But let's say that luck is against them, you have a take-over target, and take-over targets create large issues of junk bonds, and large issues of junk bonds are in addition to the stock of debt which is very volatile and so on.

So that argument that we are not going to pay dividends doesn't hold any more because the shareholders says, look, my tax rate dividends and capital gains are both taxed at the same rate and why should I take your word for it that capital gains will compensate me. I would rather see the dividends.

So dividend payment, more equity finance and somewhat less susceptibility of the corporate sector to a large load of debt I think are a very important likely outcome form the tax bill, and at the same time the resulting downward pressure on interest rates I think will mitigate or, if not mitigate, erase the upward pressure on the cost of capital that comes from the rescission of ITC.

So in my view the investment incentives under the bill are different, but overall unchanged.

I was reading the newspaper this morning and it was reporting on the drop in investment plans for 1986, and I guess it is the "nth" survey that the Commerce Department has said, and it said that people had revised downward their investment plans since May.

I asked myself what do I know now because of the rescission of the investment tax credit. Well, anybody in the corporate sector who finds with surprise that rescission of the investment tax credit is a part of the conference agreement has been asleep since November of 1984. It is hardly a surprise that the bill rescinds the investment tax credit.

I think that most of the negative effects, and there would be some negative effects, have already occurred. When you take away that incentive you get a temporary slowdown in investment spending, but remember investment spending is done by people who are looking ahead.

I think the bulk of the slowdown occurred in investment probably occurred in the first quarter of 1986 when investment dropped off at a 15 percent annual rate. What happened was that a lot of people anticipated the removal of the credit on January 1, 1986. So you had a brief acceleration of investment spending at the end of 1985. The first quarter of 1986 was very weak. It was still negative at 2 percent annual rate in the second quarter, the point being that I think we have already seen most of the negative effects.

Well, let me just finish by speculating on where we might go from here.

I was in the audience when Chairman Rostenkowski made his comments on the conference agreement on the prospects for possible future action on tax policy, and I must say I was appalled to hear that having worked for 2 years to lower tax rates the next step was to put them back up again.

I think that would be a very negative sequence to this whole activity. My own preference is somewhat different, but I agree with Harvey that probably the No. 1 order of business is to decide whether you want to pass this bill and pass it and leave it alone other than technical corrections and so on.

I think that what we need in this country is a rest from tax policy maneuvering. Myself, I am concentrating for next year's work on international policy problems hoping that I won't have to spend as much time trying to figure out the latest wrinkle or the latest proposal for tax reform and of course that is just analyzing it and living with it as a businessman or as an interested householder is very difficult.

I think that this bears on the issue of international competitiveness. I and my colleagues have spent a good deal of time studying the tax system of Japan. In fact, we have had two conferences with the Ministry of Finance, one at AEI and one in Tokyo. The Japanese tax system really is not very mysterious and there aren't a lot of hidden tricks in it, and it was actually, as you probably know, put together by an American.

What you find when you look at investment incentives under the Japanese tax system is that overall, although some argue that with debt finance the cost of capital is lower in Japan, overall the cost of capital in Japan is not significantly different from what it is here.

The major difference between the Japanese tax system and the American tax system is that the Japanese tax system really hasn't been changed in any major way since it was put into place. So it is fairly easy to plan.

Now the Japanese, along with some others, have got American disease of let's start fooling around with it, and I must say I am a little bit nervous to learn that the Japanese of all nations are thinking of a consumption tax, a national sales tax. In my view, we need a consumption tax, but I don't think that the nation with the world's highest saving rate needs one.

What they have in mind is some compliance problems, and a national sales tax would be a way to get some revenue out of the small businessmen and farmers in Japan who are viewed as tax cheats by most of the population. So the perception of fairness is an international issue.

I will just say that looking ahead that I want to leave three facts with you.

In my view, turning to the budget deficit, unless Congress and the administration show a willingness to slow the growth of entitlement programs which like it or not are the largest and fast growing part of expenditure, required progress on deficit reduction is going to take a tax increase.

I think that an increase in the tax burden on capital beyond that represented in the conference agreement would be dangerous. I don't think that it would be possible to compensate for further increases in the cost of capital with interest rate reductions that would come from the conference agreement. So I think that to say well we are going to make up the revenue by taxing capital more heavily would be a mistake.

Then when you look at the United States in a very broad sense you see a nation that has a large deficit problem and it has a large dis-saving problem in the public sector, and that is called our budget deficit. We have a large dis-saving problem in the private sector, and that is called our trade deficit.

Now in that case, if you need more revenue, it seems to me that you kill two birds with one stone by taxing consumption. I think the consumption tax is perhaps better viewed in another light, that is it is the end to the double tax on saving approach, which is more of a mouthful, but that is really what you are doing with consumption tax.

Well, I am not going to preach to you about a consumption tax now. There are plenty of things on the table to think about the conference agreement.

Let me stop there. Thank you.

[The prepared statement of Mr. Makin follows:]

PREPARED STATEMENT OF JOHN H. MAKIN

SOME THOUGHTS ON THE CONFERENCE AGREEMENT

Overview

I wish to make four points regarding the conference agreement on HR 3838.

1. It will not precipitate a recession.

2. It does not represent an ideal income tax code, but it probably realizes about half the gains available from thorough-going reform of an income-based tax system.

3. Its major strengths are its increased incentives for economically motivated, rather than tax motivated, decisions by households and corporations and the incentives it provides to reduce the build-up of private sector debt that now threatens continued economic recovery.

4. Its major weakness is its failure to index provisions related to the taxation of income from capital. Faster inflation would reduce investment incentives because of the bill's failure to index capital gains, depreciation measures, and inventory allowances.

1. Conference Agreement Will Not Precipitate a Recession

Weakness of the economy has raised the fear that we may be poised on the brink of a recession. Therefore, it is said that the conference agreement, by increasing the tax burden on corporations especially through the rescission-of the investment tax credit, will push the economy over the brink. We may well be facing a recession, but public-sector debt accumulation (budget deficits) and private-sector debt accumulation (trade deficits), not tax policy, are the culprits.

The conference agreement raises the cost of capital by between 5 and 10 percent if it is assumed that interest rates are unaffected. Nevertheless, the conference agreement's lower tax rates and limitations on household borrowing will slow debt accumulation and produce lower interest rates. The impact will be little, if any, on the cost of capital.

If the repeal of the investment tax credit were unanticipated, it would produce a temporary, negative impact on capital formation. It is likely that the removal of ITC has long been anticipated and that its major negative effects appeared during the first quarter of 1986 when nonresidental fixed investment fell at a 15.1 percent annual rate. The decline slowed to a 2.3 percent annual rate in the second quarter. Since 1962, when the ITC was first employed, it has been modified, suspended, and reenacted eight times. The expected life of an unamended investment tax credit is two to three years. Therefore, its removal five years after its last modification in the Economic Recovery and Tax Act of 1981 should hardly come as a surprise.

2. Conference Agreement Achieves About Half the Gains Possible under a Reformed Income Tax

The conference agreement forgoes, presumably for sound political reasons, two major base broadeners: the preferential treatment of owner-occupied housing and full deductibility of state and local taxes, other than sales taxes. These exceptions to base broadening relinquish $70 to $80 billion per year in potential revenue and thereby limit achievable rate reductions and preordain an increase in corporate taxes to finance politically attractive and economically useful tax rate reductions for households and businesses.

A closer-to-ideal reformed income tax system would be the Treasury I plan of November 1984 with preferences for owner-occupied housing removed. Total welfare gains under such a plan would be roughly double those achievable under the conference agreement.

3. Major Strengths of the Conference Agreement

The conference agreement, through recession of the investment tax credit, lower corporate tax rates and lower tax rates on households--major lenders to the corporate sector--sharply reduces the disparity across tax burdens on alternative forms of investment. The agreement therefore increases the incentive for scarce investment funds to be allocated to projects that are intrinsically attractive from an economic standpoint rather than from a tax perspective.

The bill's lower tax rates and limitations on household borrowing will slow private-sector debt accumulation. The lower rates themselves plus the slower rate of debt accumulation place downward pressure on interest rates that help to compensate for the increased tax burden on new capital purchases, resulting largely from recession of the investment tax credit.

4. Conference Agreement Investment Incentives Threatened by Higher Inflation

The conference agreement's weakest feature is its failure to insulate the level and distribution of tax burdens on investment from changes in inflation. Accelerated depreciation, investment tax credits, and low tax rates for capital gains have in the past evolved as ad hoc corrections to "capital bracket creep." When inflation drives up replacement costs, unindexed depreciation schedules and inventory allowances leave corporations with artificially bloated profits and tax bills. Investors with paper gains on assets whose value has risen only with inflation pay taxes where none should be due. These shortcomings could be remedied with indexing provisions.

The major risk from "capital bracket creep" is that higher inflation will increase pressure to reintroduce these sorts of ad hoc corrections. This pressure will mean reopening the tax code every year or two as has become an unfortunate practice. The resulting increased tax code uncertainty penalizes investment by making difficult long-term planning regarding after-tax rates of return.

Summary

The conference agreement represents progress toward a more stable, less intrusive tax system. It signals a less activist role for government through the tax system, just as airline and trucking deregulation, an end to oil price controls and deregulation of financial institutions have marked a less activist role for government by other means. It also ends half a century of unsuccessful efforts to redistribute income through progressive taxes.

Looking ahead, one should keep in mind three facts that link the budget to the tax code: (1) without a willingness to slow the growth of entitlement programs, required progress on deficit reduction will necessitate a tax increase; (2) an increase in the tax burden on capital above that represented by the conference agreement could not be compensated for by lower interest rates and therefore would result in a net increase in the cost of capital and a slowdown in growth that would further increase the deficit; (3) in addition to large government dissaving represented by large deficits, America's private saving rate remains distressingly low. In sum, a country in need of revenue that saves too little ought seriously to consider eliminating or at least reducing the double tax on saving by enacting an expenditure-based tax system. Examples of an expenditure tax are the value added tax, a GATT-legal business transfer tax, or a full-scale consumption tax system such as proposed in the 1977 Blueprints for Basic Tax Reform. AEI will publish this fall a major review of the value added tax by Charles McLure, with commentary by Mark Bloomfield.

Representative OBEY. Thank you very much. Let me suggest that since we have about 7 minutes to vote, why don't we all break, go vote and we will come back so we can hear all of you.

[A brief recess was taken.]

Representative OBEY. If we could resume, please.

Mr. McIntyre, before you begin I was just told by one of the members here that so far this morning evidently the stock market is down about 20 points if anybody wants to run out and sell or buy. [Laughter.]

Mr. McIntyre, why don't you proceed.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR OF FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE

Mr. MCINTYRE. Thank you, Mr. Chairman. When you talk about the Tax Reform Act of 1986 you have to start off by talking about what it does to improve the fairness of the Tax Code, because fairness is what started this bill and what sustained it through the 2 years of legislative activity.

The public was just sick and tired of the stories of tens of thousands of very rich individuals not paying any taxes. It was sick and tired of the stories of hundreds of giant corporations that no longer paid any taxes and with a tax system that allowed most companies to pay less in taxes than the people who swept their floors or typed their letters.

This bill changes that, and that is its most important accomplishment. The tax shelters that have allowed so many upper-income people not to pay generally are not going to work any more. The companies that haven't been paying taxes are going to have to start paying again. And the money that is raised by making these changes is going to allow not only middle-income tax relief, but, in many ways even more important, it is going to allow us to return to a tax system where we don't ask the poorest people to pay taxes.

It wasn't so long ago that exempting the poor from income taxes was the general rule, as you know. It is only in the 1980's that we started to tax the poor so heavily. This bill reverses that and takes us back to the late 1970's when poor people, it was thought, shouldn't be paying Federal taxes out of money they needed to put food on the table.

When you get to the bottom line on this bill, it is undeniably much more progressive than the system it replaces. Not only are the poor taken off the tax rolls, but the changes in corporate taxes mean that those with the most ability to pay, companies and their owners, will be paying more.

Now, some people have said well, this bill isn't progressive enough. They point out that something in the order of half of the richest people in the country are going to get giant tax cuts, amounting to close to $50,000 apiece. That is true, and it is something that I have trouble with.

But, on the other hand, remember that while half of the rich people get big cuts, the other half—the ones who haven't been paying taxes—get increases of the same magnitude. And on balance, rich people will be paying about the same total taxes as they are now—except that the companies they own will be paying more.

The tax system is going to be much more fair under this tax bill, but what does it mean in terms of the economy? Well, I think it means very good things for the economy because it repudiates the system that we have been using for many, many years, and which has really reached its apotheosis in the 1980's of trying to manage the economy with tax loopholes.

That system is finally being rejected, not only because of the unfairness it created, but because it didn't work. Remember back in 1981 all the promises that were made about the economic miracles that would occur if we adopted accelerated depreciation and bigger IRA's and other tax breaks for savings and investment. But look at what really happened.

IRA's were going to lead to a big boom in personal savings. It didn't happen. Instead, the personal savings rate is down in the 1980's. That is not an accident. The whole conception that IRA's would lead to increased savings was flawed from the beginning, as some of us pointed out at the time.

Think about it for a minute, ask yourselves, Why do people save for retirement? Usually it is because they want some money to live on when they retire. That is the best reason I can think of. And what do IRA's send as a message to people? They say you can save less and still end up with the retirement income you wanted to have, and many people responded quite rationally to IRA's by saving less. On balance, I think the impact on savings, from IRA's was small and that is why we didn't see any increase in savings.

What about the corporate incentives that were supposed to increase investment? Well certainly they haven't worked. The kinds of equipment investment that were supposed to be expanded by the accelerated depreciation provisions in 1981 increased at a far lower rate in the 1980's than they did in the Carter years, which supposedly were the years of problems for capital investment.

Indeed, if investment in equipment had just continued to increase at the rate under Jimmy Carter it would be about 25 or 30 percent higher today than it turned out to be.

What about trade? We were told that tax incentives would help our trade situation. Well, since the incentives were adopted of course we have gone from a trade surplus to deficits that now approach $150 billion a year. And that is no accident, because the cost of the incentives was the big factor pushing up the Federal budget deficit and the big factor that caused the Federal Reserve to push up interest rates which caused foreigners to bid up the price of our dollar which made American goods uncompetitive in the world economy.

We hope now that that high-dollar policy has changed, and that with the lower dollar eventually we will become more competitive again, but it won't happen quickly. Markets that took a long time for us to build have been lost, not forever, but it takes a while to build them back. And, conversely, foreign manufacturers have built markets here that will take a long time to dislodge.

So we will feel the effects of that high-dollar policy for a long time, and to a large degree you can blame these very costly tax incentives that didn't do what they were supposed to do.

The message of the new tax bill to investors and corporate managers is a simple one. They should stop wasting their talent and their money on trying to beat the tax collector and go back to doing things that make real economic sense.

That means we are going to get less empty office buildings in America. That means we are going to get less leveraged leasing deals by big companies. It means that managers are going to have to go back to earning money the old fashioned way. That has to be good for America.

We did a study earlier this year on corporate incentives, looking at individual companies. The aggregate data is clear of course that investment didn't go up as was promised. Indeed, it went up much more slowly than in earlier years.

But what about looking at the details? Did companies that got the biggerst incentives invest more and did the ones who didn't get the incentives invest less? No, just the opposite.

In our report which looked at 250 companies, the companies that didn't pay any taxes because they got the biggest incentives cut back on investment and they cut back on employment. Conversely and ironically, the ones who paid the most taxes increased investment and increased employment.

I don't think that is an accident either. Corporate managers only have so much time and they only have so many resources to spend, and when they spend them avoiding taxes they don't spend them making a better product, marketing it better, and creating jobs. That is going to turn around.

We are now in the process of giving back to the private sector its proper role in the economy. Business is supposed to make investment decisions and consumers are supposed to create the demand that fuels those investment decisions—not the tax-writing committees here in Washington trying to decide what is good for the economy. We just don't know and we end up with things we just don't want.

At the same time that this bill strengthens the private sector, it also strengthens the ability of the Government to perform its role, its role in improving the schools, defending the country, and also its role in making responsible fiscal policy.

You know it wasn't very long ago that people were telling us, people who were opponents of tax reform, that the income tax was worn out, that it wasn't going to work any more, that people didn't support it and that it was so ridden with loopholes that it didn't and couldn't raise enough money. And so, they said, we really had to look elsewhere if we were going to raise revenues.

They said that the public was so opposed to the Federal Government and its tax system that the only way to raise revenues would be to fool the public. Let's impose some kind of hidden increase in excise taxes or let's have a hidden sales tax, a "value-added tax" included in the price of the products. People won't know about it and that is the way we can balance the Federal books.

Well, maybe they were right that in the old days the only way to raise revenues was to try to fool the public. But we don't have to fool the public any more, because now that we have moved back to a tax system that I think you will see growing respect for as the public understands what this bill has done, I think the public is going to be willing to listen to reasonable calls for raising revenues if that is necessary.

At the same time the broader based income tax that we now have makes it much easier to raise revenues if it is necessary. We don't have to talk about raising taxes a lot on the people who are paying them. Now we can talk about raising taxes a little on a broad base of people, because we have now brought back into the tax system so many who weren't paying their share.

So both politically and substantively we have changed the dynamics of the usefulness of the income tax in raising the revenues that we need to fund the Government.

So when you talk about what this is going to mean for revenues, don't listen to anyone who gives you the kind of supply side promises you heard back in 1981. We are not saying that this bill, because it improves the allocation of resources, will increase revenues by some stratospheric amount. That is not going to happen. It will help, but the way that this bill makes the tax system better for fiscal policy is precisely because it makes it fair.

So what does that mean for the future in detail? Well, there are warts in this bill, or I should say there are omissions in this bill, and whether it is chicken farmers or whether it is the tax treatment of defense contractors or whether it is cash accounting for lawyers or a variety of other items that didn't quite make it all the way through, there are still some areas for further improvement in the income tax, areas that could be addressed to help raise money.

In addition, when you look at the funny rate schedule that the bill has for 1988, you scratch your head and you say, OK, 15, 28, 33, 28—wait a minute, why did we do that? Well, we know why we did it. We did it because the Senate Finance Committee needed a low top rate in order to sustain the bill politically. But in the future that doesn't have to stay that way.

Just to extend the 33 percent rate to the very richest people and not just to the near rich raises about $10 billion or so a year. Alternatively, maybe we will talk about freezing the 1987 rates for a while to raise money. That approach raises it even more.

In neither case, does it affect most of the public, and in neither case, I think, do you get a bad political reaction to it. I guess we will see. But I think there are ways to make this bill fairer, by curbing abuses and by looking at that unusual rate schedule, that also raise money, a lot of money to help deal with the deficit in the future.

So in conclusion, I think this bill is very good. It is very good for American taxpayers and I think in the long term is very good for the American economy. I encourage all of you to vote for it with great enthusiasm and go home and brag about it to your constituents.

[The prepared statement of Mr. McIntyre follows:]

PREPARED STATEMENT OF ROBERT S. MCINTYRE

What does the tax reform bill mean for tax fairness?

The tax bill takes giant steps in restoring fairness to the federal income tax code. Tax shelters that have allowed tens of thousands of the wealthiest people in the country to pay little or nothing in federal income taxes have been curtailed. Corporate giants with multi-billion-dollar earnings no longer will pay less in taxes than the people who work their assembly lines, sweep their floors or type their letters. The federal government will stop taxing people into poverty; in fact, more than six million poor families have been removed from the income tax rolls entirely. It can be debated whether the new tax code is progressive enough, but it is inarguably more progressive and more fair than the system it replaces.

What does the tax bill mean for economic growth?

The tax bill repudiates the old approach of trying to manage the economy with tax loopholes, not only because it was unfair, but also because it has been proven a failure. Tax incentives were supposed to have produced more savings, more investment, more jobs, and a better trade balance. But look at the actual results. Despite the 1981-enacted expansion in IRAs and other "savings incentives," the personal savings rate has fallen in the 1980s. Despite giant new tax breaks for corporate investment, from 1981 to 1985, business investment in the kinds of new equipment that were supposed to be stimulated grew at only one-fourth the rate of increase from 1976 to 1980. The unemployment rate has remained unacceptably high throughout the 1980s. And the overall U.S. trade balance has gone from a *surplus* in 1981 to deficits that set new records every year.

The message of the new tax bill to investers and corporate managers is to stop wasting talent and money on trying to beat the tax collector and go back to activities that make real economic sense. It's hard to imagine that getting people and corporations out of tax shelters and into more productive investments won't be to the long-term benefit of the economy.

What does the tax bill mean for future fiscal policy and deficit reduction?

Only recently, there were those who claimed that the income tax was "worn out," that the only way to raise revenues needed to reduce the federal budget deficit was to look beyond the income tax, toward hidden increases in federal excise taxes or even imposition of a new, hidden federal sales tax. Yet these kinds of regressive tax increases were so unfair that they were intolerable, both substantively and politically.

But the tax bill has rejuvenated the federal income tax. The fairer, broader-based income tax that tax reform has produced will help restore the public's faith in the way we pay for our government and make responsible fiscal policy, including fairly-shared tax increases if necessary, much easier to accomplish in the future.

Representative OBEY. Thank you very much. Mr. Chimerine, please proceed.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS

Mr. CHIMERINE. Thank you, Mr. Chairman. I have a prepared statement which I think has arrived and probably has already been distributed, and I request it be included in the record.

Representative OBEY. Sure.

Mr. CHIMERINE. I would like to briefly summarize some of the points I made in that statement, particularly those that bear on the questions you and the other committee members raised in your earlier remarks.

I, too, applaud the conference committee for producing a bill that is laudable in many respects, particularly the broadening of the tax base, some of the tax cuts for the very poor, eliminating tax shelter activities, equalizing the tax burden across different individuals and different industries, closing loopholes, and so forth. All of that is not only laudable, but quite frankly is long overdue.

I share Mr. McIntyre's view that the big benefit from all these changes is in the area of fairness and equity. It does make the system, or it will make the tax structure, much more fair and much more equitable than it has been in the past and there may even be more marginal benefits in efficiency which might help the economy on a long-term basis.

But it strikes me that there are other issues that have to be addressed in assessing the impact of the tax reform legislation, particularly what it might mean for the economy.

I would like to spend a few moments talking about the potential short-term impact, and then look at some of the long-term effects that could result from enactment of the conference committee bill.

My main concern in the short term is that the economy is quite vulnerable at the moment, as you know, Mr. Chairman. We have talked about this several times before at hearings held by this committee. The economy is quite weak, and despite what the bond market seems to believe right at the moment, I see no evidence whatsoever that we are breaking out of this trend of very slow growth, or in fact, almost stagnation, that we are in.

The underlying fundamentals are quite poor. Most companies are cutting investment, perhaps partially because of tax reform, and more likely because of other factors such as the enormous excess capacity which exists. Many of our clients are telling us that they have now completed large parts of their modernization programs, and if you don't invest to modernize and if you don't need new capacity, there isn't any other reason to do so.

Profits are sluggish, and real interest rates for industrial companies are still very high, which makes the cost of external financing quite high. For all of these reasons, and a number of others I didn't mention, the prospects for capital spending, particularly in the near term, are very poor, and as the chairman mentioned earlier, each new survey shows a weaker trend for capital spending despite declining interest rates.

Again, some of the weakness may be tax reform related, but much of it is not, in my judgment. The fundamentals are either weak, or certainly not very favorable, for other sectors of the economy. Without going through them all, the best that we can conclude about economic prospects for the United States for the rest of this year and 1987 is that slow growth may continue, if we are lucky.

Most of the risks are on the down side since we are already very close to recession, and certainly a recession is not out of the question given some of the problems that I have mentioned and some of those I haven't even referred to.

My concern, therefore, about tax reform is that we are potentially adding another short-term negative in an environment which is already very soft, and it could worsen the situation. The impact of tax reform will depend on the starting conditions. If the economy was more vibrant, and if we had great capacity needs throughout the economy and capital spending was strong and other conditions were more favorable, then we could probably absorb the impact of tax reform quite easily.

But in the conditions which now exist, that is very doubtful, and while I wouldn't go as far as to say that tax reform will cause a recession, it certainly will increase the risk of recession in the near term.

It will particularly, in my view, cause more sizable cutbacks in construction and investment than would have taken place. Some of the cutbacks in construction are desirable on a long-term basis. We don't need any more empty office buildings or hotels and I think we are over-shopping centered, and I can go down the whole list.

But, unfortunately, if that process of decline gets speeded up by tax reform, it harms economic activity. Even "bad investment"—in terms of whether it generates productivity improvement for the economy—helps the economy on a short-term basis. By exacerbating these trends, we will speed up the decline, not only in construction activity, but potentially in the economy in general.

The same is true for investment. Tax reform will increase the cost of capital about 10 percent by our calculations. I doubt very much whether reductions in interest rates will offset that. And what is most disturbing about the way the bill has been structured is that we are raising taxes on new investment and reducing taxes on old investment which I am not sure is the way we want to go in an environment when investment is already quite weak, when we have the kinds of problems we have in world markets, and the poor productivity trend in the United States, and some of the other underlying problems, which exist in the economy.

There are a couple of other reasons that suggest a somewhat negative short-term impact from tax reform.

First, there is going to be a lot of confusion with respect to personal income taxes. We will have this temporary rate structure in 1987, and then go to another one in 1988. Most people are not going to know whether or not their taxes have gone up or have gone down probably until 1988, and in some cases until 1989.

I think this is going to cause some caution in making new commitments, and the benefits we would likely eventually get from higher consumer spending as a result of the reduction in personal taxes could be delayed, and therefore, provide only a partial offset—or no offset—to the cutbacks in other sectors that we are likely to see in the short term if the legislation is enacted.

Second, while business taxes are increased, some companies, particularly in the service sector, will see their tax burden reduced because of the reduction in corporate tax rates.

Generally, these companies are not very capital intensive. In my judgment, the so-called losers, the ones who will see their tax burdens rise, will respond much more quickly than the ultimate winners.

So, on a short-term basis, the negative effect on investment could even be larger than it might be 4 or 5 years down the road.

I am particularly worried about this because of some of the things that have happened in recent years, particularly the pileup of corporate debt. A lot of our clients are telling us that they are scaling back their investment programs now because the cost of servicing debt has increased dramatically. This is using up a much larger fraction of their cash-flow or profits.

They don't want to go deeper in debt in view of the uncertain environment. And, many of the leveraged buyouts in the last 2 or 3 years were based on predictions of cash-flow which could service the debt incurred in the process—now that cash-flow may be reduced because of tax reform. This creates a burden which will cause expenses to be cut, or cutbacks in new investments, or some of both.

So I think the short-term effects are very likely to be negative. It is very difficult to estimate how much, but when we are already growing very, very slowly, in my judgment, that seems like an awfully large risk to take.

I will add one other factor to that. The lack of grandfathering provisions in the legislation is likely to cause a significant decline in the value of certain assets which, given current financial strains, can cause other problems and again lead to a more widespread problem of retrenchment throughout the economy.

In sum, I think the short-term effects are very likely to be negative, and given the situation that already exists, I am quite concerned about it.

If we look further out, at a 5- or 10-year horizon, it is even more difficult to measure the economic impact of tax reform than in the short term. The best we can do is to look at some of the likely directional impacts and look at what tax reform might do in helping solve, or in fact, exacerbate some of the problems which the economy is already likely to have on a long-term basis.

So I am going to refrain from any quantitative estimates and discuss the long-term impact in that context.

First, as several of us have mentioned already, and I referred to a moment ago, there clearly will be an increase in the cost of capital on a long-term basis, an increase in the cost of new investment.

It is an open question whether we will get sufficient declines in interest rates to offset that. I personally doubt it. If that is the case, this would generate somewhat of a downward bias on investment in the long term.

Second, several members of the committee mentioned the trade problems we are suffering from, and I realize I am probably more concerned and pessimistic about our trade situation than most, but quite frankly I think it is very serious.

We have an extremely serious underlying competitive problem in the United States that goes well beyond exchange rates or the increase in the dollar that took place in recent years. In fact, in my judgment, our trade problems probably started 10 years ago but were temporarily hidden by a number of factors that helped our trade deficit in the late 1970's.

As you might remember, our exports to OPEC countries jumped sharply in the late 1970's when they began to spend their oil revenues. And our exports to Latin America boomed, financed mostly by soaring bank loans.

Third, by most measures, the dollar was undervalued during much of the 1970's, particularly during the latter part of the decade. This helped increase our trade surplus with Europe. These factors temporarily made our trade deficit improve, and look a lot better than I think our underlying competitive conditions would have suggested in the late 1970's.

Once these temporary factors began to be reversed, our trade patterns would have worsened dramatically even without the change in exchange rates. Admittedly, the rise in the dollar made them even worse, but what I am saying is that we would have had a serious trade problem even without the dollar having appreciated so much.

Now that the dollar is coming down, there seems to be a widespread expectation of a dramatic improvement in the trade deficit. I doubt it very much. I think it will improve extremely slowly, primarily because the decline in the dollar has been very limited.

Countries such as Korea, Taiwan, and so forth now have the same mass production capabilities we do, the same technology we do, and if anything, they have more modern equipment. And, of course, they have labor cost advantages that are extremely large. Fundamentally, the competitive advantage that we had in world markets for much of the postwar period is now over and we are going to suffer on the trade front, in my judgment, for many years.

Furthermore, we have had very little improvement in productivity in the last several years. It is lagging well behind other recoveries, and most of what we have obtained simply reflects reductions in people and not something more fundamental.

Given these concerns, and given that tax reform may bias the economy toward less investment, we may further reduce productivity growth on a long-term basis. And with manufacturing already in the pits, with the capital goods sector of the economy already suffering, this goes in the wrong direction. Tax reform could hurt capital goods producers in two ways, by reducing the demand for capital goods, and by making it more expensive for our capital goods producers to modernize themselves. It seems to me that we are going too far in the direction of raising the tax burden on corporations in this tax bill, and of increasing the cost of capital, because there is the risk this will exacerbate some of the problems the economy is already suffering from, and is likely to continue to suffer from, as we look 5 or 10 years ahead.

Yes, efficiency benefits will help, but it is an open question as to whether they will offset the direct impact of increase in the cost of capital. And, as Bob McIntyre mentioned a moment ago, we learned from the 1981 tax cuts that the incentive effects from marginal tax rate cuts have been enormously overstated and are not likely to contribute much to saving, investment, work effort, and so forth.

So, on that basis, my feeling is that tax reform will be anywhere from neutral to somewhat negative for long-term growth. It will potentially exacerbate some of the problems we already have.

With respect to budget deficits, I think I have a somewhat different view than has been expressed by some of my fellow panelists. I think the deficit problem is incredibly serious. What bothers me most about it is that the outlook is still absolutely horrendous, as is now being revealed around this town. The optimism about the deficits which surfaced 6 months ago was not justified. We are in for another $200 billion deficit in the coming fiscal year, or very, very close to it, once you cut through the gimmickry and take away the overly optimistic assumptions.

It is likely to stay that way for several years, and my concern is that deficits of this magnitude will continue to put upward pressure on the Federal debt to GNP ratio. To me, that is the relevant measure, not the deficit. We have to stop the upward trend in that ratio, and we can't do that until we get these deficits down sizably.

I don't understand the logic of completely revamping the tax structure and not doing it in a way that makes some contribution toward reducing the deficit. In fact, I think there is probably a good chance that this tax reform bill will be a revenue loser, mostly because it probably overestimates the amount of revenue gains we will probably get from eliminating the lower tax rate on capital gains. And, there are going to be new loopholes found and new ways to get around the tax structure.

So this is probably going to exacerbate the deficit problem, and I have a hard time understanding why we permit that to take place, particularly since it would be relatively easy to incorporate deficit reduction into tax reform, and especially since we are going to need some more tax revenues if we are really serious about reducing future deficits. This would be an ideal way to do it, in my judgment.

There is nothing magic about 15/28. We could have easily gone to 17/30, phased in in a proper way, and use those added revenues down the road to reduce future deficits.

What would I do after having said all this? Well, I would like to see a tax reform bill passed because I do think it is important for fairness and for economic efficiency. But I think there are three or four changes that can be made to reduce the risks associated with this bill from the standpoint of the impact on the economy.

First, I don't see the logic of shifting the tax burden so dramatically away from individuals to corporations. Some increase in corporate taxes is clearly justified. We went too far in the other direction in 1981, particularly for those sectors which have enormous tax advantages, such as real estate and those industries that are paying little or no taxes. There is no question that we ought to raise taxes on those sectors.

But this bill goes well beyond that, and is increasing tax burdens on those industries that are suffering.

My preferred way of reducing the increase in corporate taxes, and nobody else on this panel is going to agree with me, is to maintain at least part of the investment tax credit. In my judgment, we get more bang for the buck on new investment from the investment tax credit than from any other kind of investment incentive, including corporate tax rate changes.

Second, I would raise personal tax rates from the 15, 28, 33 combination in the conference bill, for two reasons.

First, we would need the extra revenues to offset the revenue loss from maintaining part of all of the investment tax credit and, second, because we need to raise some additional revenues down the road to reduce further deficits.

Again, this will still leave the tax structure with a much broader base and with much lower marginal tax rates than we have had before.

And, third, to reduce some of the short-term risks, I think we ought to seriously consider phasing in tax reform over a longer period of time, rather than doing it all in one shot.

Changing the structure gradually over a period of 3 to 4 years, and with more effective grandfathering of existing provisions, would tend to minimize some of the short-term risks in terms of the near-term economic outlook. Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine, and I am the Chairman and Chief Economist of Chase Econometrics. I appreciate this opportunity to testify before the Joint Economic Committee on the likely economic effects of the Conference Committee tax reform bill.

Summary

In brief, my views are as follows:

(1) There is a strong likelihood that tax reform will have at least a modest depressing effect on the economy in the short run, reflecting the sharp reductions in the incentives for investment and the tax advantages for construction, and the likelihood that the "losers" from tax reform will respond more quickly than the "winners." The short-term effects are likely to be exacerbated by the already weak investment and general economic climate.

(2) Some argue that the incentive and efficiency effects of tax reform will lead to significantly higher long-term growth. In my judgment, currently available evidence does not support this conclusion. In fact, the increase in the cost of capital which will occur creates a signficant downside risk -- it may be unwise to take these risks in view of the low rate of capital formation, savings, productivity growth, and the poor international competitive position, which already characterize the United States economy.

(3) While the Committee bill is now deemed to be revenue-neutral over the next five years, there is a significant chance that it will actually be a revenue loser during this period, thereby increasing already enormous budget deficits.

(4) Because tax reform is desirable on both efficiency and equity grounds, I believe that comprehensive tax reform should be enacted. However, several changes to the current proposal should be considered in order to reduce the risks referred to earlier. These include: **(a)** a phase-in of some of the major provisions, **(b)** a smaller shift in the tax burden from individuals to corporations, and **(c)** combining tax reform with deficit reduction in order to reduce future deficits.

INTRODUCTION

The tax reform legislation that appears almost certain to be enacted during the weeks ahead represents an extremely far reaching and comprehensive change in the tax structure. In my opinion, it represents a major step forward because of its significant broadening of the tax base, because of its dramatic scaling back of tax shelter activities, and because of its reduction in marginal tax rates. These changes will make the tax system much more fair and equitable than the current system by dramatically reducing the number of tax paying units that pay little or no taxes (but which have relatively high incomes), by coming reasonably close to equalizing the tax burden for individuals and corporations in similar circumstances, and by reducing the significance of tax considerations in decision making.

Because of the widespread scope of the legislation, the tax reform bill can potentially have significant impacts on the economy as well. However, despite advances in the science of economics over the years, measuring these impacts remains extremely difficult. Even macroeconomic models are somewhat limited in analyzing the effects of tax reform, in part because many of the changes are microeconomic in nature and cannot be captured precisely in these models; in part because many of the provisions are so different from current law that they do not fit comfortably into the structure of these models; in part because some of the most dramatic changes are either poorly understood and/or are difficult to measure; and in part because some of the changes are well outside the range of estimation of most existing econometric models. Nevertheless, macroeconomic simulations can be a useful tool for determining the directional changes and the rough orders of magnitude one would expect from proposals of the type currently under consideration, especially since secondary impacts, such as the feedback from reduced investment expenditures, or the increase in consumption due to increased dividend payments, can be taken into account with these models.

Thus, while I will show the quantitative results of one simulation, I will focus primarily on the direction of change. I will also attempt to analyze the economic effects of tax reform in the context of other economic objectives, and of prevailing and expected economic conditions.

SHORT-TERM EFFECTS OF TAX REFORM

In analyzing tax reform, it is extremely important to differentiate between the likely short-term effects and the long-term impact. This is important for several reasons. **First**, it is much easier to measure the likely effects on demand in the short term than the incentive and efficiency impacts that take many years to build. **Second**, any proposal that would cause serious short-term economic weakness may create sizable damage to the economy which may not be offset for many years. **Third**, the U.S. economy is now particularly vulnerable to any change that would cause negative short-term shocks, especially in view of the relatively slow growth during the last two years, the current strains in the financial system, the possible short-term restrictive effects of deficit reduction, and the age of the current expansion.

Any assessment of the likely short-term impact of comprehensive tax reform will thus depend on the starting conditions and on other key assumptions. As mentioned above, the current economy is extremely vulnerable to any negative shock because of its less than healthy condition. The economy has been far weaker than many have claimed in recent years, despite the strong recovery. In part, this results from the fact that the recovery was rapid only for a very limited period, namely during 1983 and the first half of 1984. Furthermore, the misinterpretation of economic performance has in part resulted from a failure to distinguish between the **direction** and the **level** of economic activity -- while the recovery in 1983 and the first-half of 1984 was strong in terms of magnitude of increase, the **level** of economic activity was still considerably below its potential. This reflects the extremely weak conditions from which the recovery began because of the severity of the 1981-82 recession, and the fact that it followed so closely on the heels of the previous one. In fact, unemployment, capacity utilization, profits, and other important measures of economic performance were still far from satisfactory in mid-1984, and in most cases, had not even returned to the relatively sluggish levels which existed in the late 1970s. Several industries and geographic areas were particularly depressed (and still are), having experienced virtually no recovery at all, indicating both a high degree of imbalance in addition to the far from healthy overall picture. Furthermore, growth has slowed sharply since mid-1984 (and even further in the last several months), to a less than 2.5% annual rate, despite the fact that the recovery is far from complete.

The recent statistics suggest that the economy remains mired in the slow growth pattern that has prevailed since mid-1984, and that the following major trends are in place: **(a)** While consumer spending grew sharply earlier this year, the growth in household spending now appears to be slowing. This reflects the continuing sluggishness in wages and salaries, coupled with a saving rate that seems to be stabilizing in the 4% to 4.5% range, and a reduced willingness and/or ability of many families to continue to increase their debt burdens. **(b)** It appears that housing activity peaked earlier this year because many families jumped into the market to lock in funds before rates moved back up -- there is thus not likely to be any new surge in housing activity in response to renewed declines in mortgage rates during the next several months. Furthermore, multifamily construction will taper off in view of the declining sales levels of condominiums and the high vacancy rates for rental apartments in most areas, and the likely scaling back of industrial revenue bond financing. **(c)** Investment remains very soft -- while orders for computers have apparently rebounded somewhat, and orders for commercial aircraft remain strong, orders for other kinds of machinery and equipment have actually fallen during the last month or two. All other forward indicators, such as spending plans, appropriation rates, orders, etc. also indicate that capital spending will stay weak in the near future. **(d)** The trade deficit remains extremely high -- while this in part reflects the familiar J-curve, it also reflects little or no improvement in real trade flows thus far. **(e)** While Federal spending has accelerated recently, the growth in expenditures by state and local governments is being scaled backed in response to underlying budget weakness. This of course will be compounded by a sharp slowing in expenditures at the Federal level later this year. **(f)** Although the decline in industrial production was very small in July, the weakness in the industrial sector is continuing. Furthermore, in view of the flat pattern of orders in recent months, there is no sign of any imminent sustainable rebound in industrial activity.

Thus, there remains no evidence of any significant improvement in the economy at the present time — it is thus still growing only very slowly at best. I believe that tax reform will have a moderate additional dampening effect on the economy in the near term, creating an increased risk of recession, reflecting the following: **(a)** It will raise taxes in 1987. **(b)** The temporary personal tax rate structure for 1987 could cause some household spending to be delayed. In particular, most households are unlikely to know whether their tax burden has been increased or reduced as a result of the new legislation until at least 1988 -- thus, any increase in after-tax income will not likely show up in consumer spending immediately. **(c)** The "losers" of tax reform in the business sector will likely respond more quickly than the "winners," so that investment will remain weak. In particular, the elimination of the investment tax credit, reduced depreciation and other changes, will combine to significantly reduce the expected after-tax return on investment projects for many companies. On a net basis, these changes add up to a sizable increase in corporate taxes in the short term, even with the lower corporate tax rate provided for in the bill. Given the stagnant investment climate that has already developed as a result still high real interest rates, sluggish demand, low and falling capacity utilization, and high corporate debt, investment will likely weaken further, especially since it will take many years for many of the companies that will benefit from lower corporate tax rates to gear-up their investment programs (since most are not highly capital intensive). **(d)** Without the current tax advantages, many of the construction projects that are now being considered, especially for office buildings, shopping centers and apartment buildings, could not be justified. Vacancy rates are already extremely high for these types of structures, with relatively soft demand and declining rents in many areas. Thus, the decline in construction which is already occurring will be aggravated in the short term by enactment of the tax reform proposal. And, it matters little for near-term economic activity and employment whether the construction and capital spending projects that will be cancelled or abandoned are good projects (that is, would have an acceptable rate of return even without some of the current tax benefits), or whether they can be justified only because of tax considerations. **(e)** The change in tax laws is also likely to reduce new tax-exempt municipal government financing (and thus infrastructure - type spending by municipal governments). In addition, tax reform will reduce the incentive to borrow by both businesses and individuals -- while this is desirable on a long-term basis, it could further slow economic activity in the short term. Finally, because of the absence of grandfathering provisions, tax reform could cause a sharp decline in the value of certain existing assets, resulting in numerous defaults and bankruptcies -- this could have serious repercussions for financial institutions.

Table 1 shows my estimates of the net impact of tax reform on the economy in 1987, assuming a January 1, 1987 effective date. As can be seen, I expect real GNP growth to be almost .5% lower than would otherwise be the case -- furthermore, I strongly believe that the risks are on the downside; it is more likely that the effects could be larger than I've estimated, rather than smaller. In view of how sluggish the economy already is, and in view of the already serious strains on the financial system (which could become far worse if the economy slows further), this seems like a large risk to take.

Econmic Impact of Tax Reform
In 1987

Components of Real GNP	Percentage Impact
Total	-0.4
Consumer Spending	0.0
Business Investment	-3.1
. Producers' Durable Equipment	-2.2
. Nonresidential Structures	-5.4
Residential Construction	-0.4

LONG-TERM EFFECTS OF TAX REFORM

As discussed earlier, it is far more difficult to assess tax reform's likely impact on economic growth in the long term. However, I believe there are several reasons to be concerned, and that there is more than an even chance that economic growth will actually be lower on a long-term basis.

1. The user cost of capital for investment in new equipment will rise by approximately 10% on a long-term basis, reflecting the elimination of the investment tax credit, somewhat less favorable depreciation, and other provisions of the tax legislation (these more than offest the reduction in corporate tax rates). The increase in the user cost of capital for structures would be even larger. This is likely to reduce investment on a long-term basis. I believe the impact of the rise in the cost of capital will be even greater than it might otherwise have been because prospects for capital formation on a long-term basis are already relatively poor in view of the high corporate debt burden which already exists, the widespread excess capacity (which will take many years to overcome), weak profits, and other factors.

2. In my view, both the efficiency and incentive effects which are now expected are being vastly overstated by many -- experience since the sharp reduction in marginal tax rates in 1981 is not encouraging. Thus, these factors will not raise growth significantly.

3. The U.S. competitive position in world markets remains extremely poor despite the recent decline in the value of the dollar. U.S. competitive problems, while worsened dramatically by exchange rate changes in recent years, were already becoming very serious in the late 1970s, but were temporarily masked by several factors, including: **(a)** the sharp increase in U.S. exports to Latin America and other developing countries, which were largely financed by a temporary surge in bank lending to these countries; **(b)** sharply increased exports to OPEC countries in response to higher oil prices (although a sharp change in the terms of trade worsened the U.S. current dollar trade deficit with OPEC, the **real** trade deficit actually improved, reflecting the increase in the volume of exports to OPEC countries as well as the decline in the volume of oil imports); and **(c)** the undervalued dollar of the late 1970s enabled the United States to temporarily improve its trade position with many of the European countries. All of these factors were unsustainable -- their reversal in recent years, as well as the increased use of very cheap foreign labor, spreading technology and production expertise, the increased willingness of U.S consumers to purchase imported goods, and increasing agricultural productivity in many other parts of the world, would have produced a large trade deficit for the United States even without the enormous overvaluation of the dollar in the early 1980s. In addition, the decline in the dollar has been limited to currencies of the large European countries and Japan -- thus, using weights based on current trade patterns, the trade-weighted decline in the value of the dollar against **all** currencies has been less than 10.0%. This, coupled with the narrowing of previously large foreign profit margins in U.S. markets, has led to only limited increases in import prices (with respect to both magnitude and coverage) thus far. The perception of higher quality for some foreign products, and the lack of comparable domestically produced goods for others, have also limited the effect of these price increases on the demand

for imports. And, the Japanese and many European countries are now making stronger efforts to control costs (including more outsourcing) in order to offset at least some of the effects of their strengthening currencies on their competitiveness. Thus, real imports of consumer and capital goods will decline very slowly. In addition, exports are recovering only marginally, reflecting very sluggish domestic demand in most major industrial countries, recessionary conditions in Mexico and several other LDCs, and the cutbacks in overseas distribution networks in recent years. Finally, the large amount of recent outsourcing, especially the shift in production overseas, will not be reversed quickly. These and other factors are likely to keep our trade deficit very high for several years at least, even with a depreciating currency. By reducing the incentives for investment and by potentially slowing long-term productivity growth, tax reform would not only make no contribution toward alleviating our poor competitive position, it could actually worsen it somewhat.

4. Tax reform could aggravate problems in those sectors of the economy which are already experiencing very sluggish conditions. Capital goods producers, in particular, would be hurt, both by reduced demand for their products as well as by the fact that the higher cost of capital would make it more difficult for them to modernize and lower their costs. Other parts of the manufacturing sector could also be hurt.

It should be noted that while these factors would hold down investment, productivity growth, and economic growth on a long-term basis, there would be partial offsets. In particular, both a modest additional decline in interest rates resulting from tax reform, as well as the accelerator effect from rising consumer spending, could work in the other direction. Thus the magnitudes of the changes are extremely difficult to pin down — the evidence does suggest, however, that the net impact is likely to be somewhat on the negative side, and that there is a risk that these negative effects could be quite large (especially in view of the already serious problems which exist). In my view, these risks appear to be too large to accept.

TAX REFORM AND THE DEFICIT

Perhaps another major reason to be concerned about tax reform is that it does not address one of our other most critical problems, namely the enormous budget deficit. Despite the optimism which prevailed earlier this year, it is now clear that the underlying deficit situation remains bleak — using realistic assumptions, the deficit is likely to remain in the $200 billion range for the remainder of the decade. This would imply continued increases in the Federal Debt/GNP ratio, which would keep real interest rates too high, and/or prevent the dollar from adjusting further than it has, and/or put the Federal Reserve in a position of having to monetize these deficits, thus causing a major acceleration in inflation. Any or all of these factors could produce long-term economic stagnation. Furthermore, the longer that deficit reduction is put off, the larger that future interest payments will be, and the larger that tax increases for the next generation will have to be. **Finally,** an increasing share of the Federal debt is now being financed overseas, so that more and more interest and dividend payments will leave the country in future years, sucking income out of the United States economy.

Despite the horrendous deficit outlook, and the potential consequences, the tax reform proposal about to be passed will produce a major restructuring of the tax structure without addressing the deficit problem -- in fact, the Committee bill may actually widen future deficits because new "loopholes" may be found to offset some of the gains in revenues from closing existing loopholes, and because the increased revenues from eliminating the capital gains tax is probably being overestimated. In my view, this is a serious error, especially since it should now be apparent to virtually everyone that additional tax revenues will be necessary to reduce future deficits.

Recommendations

In my view, the tax reform legislation can be modified in order to reduce the adverse effects, and risks, that have been discussed above, while at the same time still producing a new tax structure which is far more equitable than the existing one. I suggest the following changes:

1. I believe that the shift in the distribution of the tax burden from individuals to corporations should be reduced from what is implicit in the current bill. Clearly, some increase in corporate taxes is justified because the reduction in corporate taxation in 1981 was too large -- furthermore, many companies (even whole industries) are now paying no taxes. However, the committee bill goes too far in this direction in view of the already sluggish capital spending environment, and in view of some of the long-term problems dicussed earlier. The best way to accomplish this would be to maintain at least a portion of the investment tax credit -- the credit has proven to be very cost effective in stimulating investment relative to other incentives.

2. I believe that personal tax rates should be made somewhat higher than the 15% and 28% rates in the Conference Committee bill. This is necessary for two reasons. **First,** additional revenues will be required to offset the revenue loss from retaining at least part of the investment tax credit. **Second,** and equally important, it is highly desirable to combine tax reform with deficit reduction -- thus, the tax reform bill should be structured to produce a modest increase in revenues on a long-term basis, instead of being revenue neutral (or a revenue loser). This is desirable because it is now clear that it will be virtually impossible to get future deficits down significantly without some additional revenues. Furthermore, the distribution of the tax burden has been made considerably less progressive in recent years -- using sales taxes to raise revenues in the future would aggravate this trend. The increase in taxes should be pushed out a year or two in order not to increase the risk of recession in the short term.

3. In order to reduce the transition problems, I would suggest a more gradual phasing-in of the some of the major changes; more effective grandfathering of various existing provisions; and a more careful selection of effective dates in order to avoid any near-term tax increase.

Representative OBEY. Thank you. Mr. Minarik, please proceed.

STATEMENT OF JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE

Mr. MINARIK. Thank you, Mr. Chairman. I found your opening statement and the opening statements of Congressman Scheuer and Congressman Wylie very useful.

I would like, with your indulgence, to submit my prepared statement for the record and try to answer your questions. I think that that might be the most useful thing to do at this point in the proceedings.

Representative OBEY. OK.

Mr. MINARIK. I would like to start out, if I might, I want to handle one question because I would like to save some time. Congressman Scheuer asked about the deficit and does it matter. Yes. All right, we have one down.

What do we want to do about the deficit and what are our options?

I want to disagree a little bit with Larry Chimerine, whose opinions I respect very greatly, on one question. I don't find it terribly surprising or terribly puzzling in an atomsphere of deficits like we have today that we are passing a revenue neutral tax reform bill. As a matter of fact, I think as a first step toward reducing the deficit it is a very reasonable thing to do.

If you imagine what you would be going through if you didn't have this revenue neutral tax reform bill and somebody came along and said that he needed $10, $15, or $20 billion a year going out in to the future out of the income tax in order to reduce the deficit, I submit that without this tax reform bill passed as a prelude you would find it a lot more uncomfortable than you would with the next tax law.

The reason is that the current tax system is an extremely inefficient and extremely awkward and cumbersome way of raising money, and I think that it very well might buckle under the load if we asked it to do that job. So let me suggest that revenue neutral tax reform might be one step in cutting down on the deficit.

If I had the choices what would I do about the deficit? The first thing I would do, as Harvey Galper suggested, is to raise excise taxes: alcohol, tobacco, and possibly also gasoline. The price of oil went down and it can go back up. Somewhere vaguely in my memory I remember oil prices going up, and it seems to me it might be able to happen again.

After those things were done, if I needed more revenue, let me submit that in my opinion the income tax as changed by the Tax Reform Act of 1986 is going to be the best vehicle for carrying that additional load that is going to be available.

My good friend John Makin has discussed the issue of consumption taxes. Let me hasten to mention one thing lest there be any confusion on the table. There are two basic types of consumption taxes. Some economists advocate a tax on consumption to completely replace our income tax, an analog to that with a different base carrying the whole load.

Other people talk about a consumption tax which is a value added tax or a national sales tax, something that would be an addon to the current system to provide an increment of additional revenue.

I think that the first topic, the complete revamping of the system to a consumption base, is really beyond the pale, and I don't want to talk about it very much except that if I had the option to do it, there is a great deal of disagreement among economists, and personally I wouldn't do it. I know there are a lot of other economists, including some at this table, who would.

But if the issue is raising "X" billion dollars per year, whatever "X" is, to cut down on the deficit over the next 5 years or the next 10 years, I would lean very heavily toward using the revamped income tax to do it against a value added tax. I think that is an important decision on grounds of fairness and I think it is an important decision on grounds of the administrative burden on taxpayers. The last thing we need is another tax, and that is what a value added tax would be.

If I were raising taxes under the income tax, and I think there will be agreement down the table, the corporate sector has taken its hit in the current tax reform bill. If you want to raise more revenue under the income tax, it has to be on the individual side. That is unfortunate, but it is true. I think we have pretty much hit our limits on the corporate side of the table.

Now let me leave that topic and move on to a second one which is again a topic raised by both Congressman Scheuer and you, Mr. Chairman, and that is the question of does this tax bill do enough for investment and does it provide sufficient incentives for us to get the investment out of the economy?

At the risk of maybe distorting just a little bit what Congressman Scheuer was saying in his question, let me say that I have a real philosophical difficulty with answering a question that is put in exactly this way. There is an underlying theme behind this kind of a question that somewhere in this tax system if we turn this deal enough we are going to get enough investment out of this system. It is just a question of turning the dial a sufficient number of clockwise turns and it is going to be there.

I have a fundamental disagreement with that. If you think of a company's choices in terms of making investment, even in the sense of how much do they want to invest, at any given time a company has a certain array of projects from which it can choose, and you can think of it almost like a bunch of apples in a barrel.

If the tax system is extremely rigorous on that company they might not even reach into the barrel at all. Loosen the tax treatment of investment and they will reach in and they will take the apples on the top of the barrel which, let's say, are the best apples. Make the tax system easier and they are going to reach in a little deeper and they are going to get some inferior apples.

You make the tax system generous enough and they are going to scrape their way through the bottom of the barrel and they are going to be digging in the dirt. That is what we are doing under the current tax system. The dirt is the tax shelter investment game that we are undertaking right now. There is no better evidence of the misguided nature of the incentives in the current tax system than the way we are spending money on building office buildings that aren't going to have any tenants, and the people who are building them know it, but it still makes money.

I perhaps have more of a concern about this problem than some other people do, but it seems to me that we are pushing our tax system very far in the wrong direction if we think by adding incentive upon incentive we are going to improve the net benefit of our investment to our economy.

What about the question of——

Representative SCHEUER. Mr. Chairman, may I ask a question at this point on this point?

Representative OBEY. I would really prefer that you hold it until he is finished with his statement. We haven't interrupted any other witness.

Representative SCHEUER. OK. Very good.

Mr. MINARIK. On the question of the trade deficit, what does the tax bill imply for the trade deficit? Let me just make one broad generalization here. If we assume that the entirety of the tax increase that is going to be loaded onto corporations is going to be added onto the prices of products, is going to go right into the price, we are talking about a shift in the prices of domestic production that relative to the shifts in the values of our currency in international markets is minuscule.

There simply is not enough leverage in this corporate tax increase to have a significant effect on our trade balance over the long term. The heart of our trade problem is the value of our currency, and we are paying some past due bills for the extravagancies that we have had over the last 5 years and, admittedly, even the rebound of our currency back down to where it ought to be is not going to eliminate that problem immediately. But if we want to deal with that problem we have to deal with our budgetary problems first. Again, I think this gets back to the question of making the appropriate budgetary choices.

Are there short-term risks in passing this particular tax bill at this particular time? I agree with Larry Chimerine entirely that this is a weak economy. I would continue to maintain, however, that if you wait for the perfect moment to pass what I think in the long term is going to be an extremely valuable piece of legislation, you might never get to it. There is always something wrong every time you want to make a broad decision, an important decision, and there is always something that makes you hold back and want to say no, let's wait until later. I don't think that is an appropriate response at this particular time.

We have to take into account I think in making this decision that the amount of negative impact of the tax bill on the economy given in particular the increase in corporate tax liabilities is quite small. Given any reasonable range, $25 billion of additional corporate taxes every year in an economy that is pushing $5 trillion, is a pretty small hit on the corporate sector.

Other policy instruments are available to us to stimulate the economy to make up for that. That includes monetary policy as well as fiscal policy, with apologies to Senators Gramm and Rudman. Therefore, it seems to me that we can make some reasonable choices and some reasonable adjustments to get what I think is a very valuable improvement in the tax system in place for the long term.

Now a question you asked, Mr. Chairman, on the rate structure. Let me emphasize, if I might, is it fair given that the tax rate on the margin goes down at some point? In my own opinion as something very close to an absolute statement, the fairness of the tax system depends on average tax rates, not on marginal tax rates.

It used to be in attempting to make this point to people who would ask people like me, you know, look at this tax rate schedule and should it go up a little higher or should it go down a little lower and what difference does it make, the answer always was, the point is what the average tax rates are.

If the average tax rates are increasing, I used to say, it doesn't even matter if the marginal tax rates go down. That used to be a joke. It is not any more. In an ideal world I would certainly not like to have that hump in the tax rate schedule.

Unfortunately, the Senate got itself in a position in the Finance Committee that that was really inevitable. It has something to do, I think to some degree, with some base broadeners that I would have liked them to have done that would have raised the revenue they needed at the income levels where it was needed, that they chose not to do.

In my own opinion it is tolerable. The system overall, as Harvey Galper said, and I agree with him completely, is at least as progressive as the current system, and I think we should be glad to accept it.

Now in answer to your question again, Mr. Chairman, what are the implications for the making of tax policy in the future, I have had my say on the deficit. Let me talk about a couple of structural issues.

I very much respect the opinions of Harvey Galper and John Makin when they talk about the need to index capital gains, the fear that they have that in a period of inflation appreciation of assets that represents only inflation when taxed at the statutory rates is going to represent an additional tax over and above what would be owed if only real income were being taxed, and that is certainly true.

I find myself a voice in the wilderness when I try to remind people that there are other problems with the taxation of capital gains. One of them is the fact that a person who has an accrued capital gain can hold on to it as long as he wants and not pay any tax.

The deferral of tax is a privilege to owners of appreciating assets which is often forgotten when discussing capital gains.

We have the problem under the current law that an individual can hold on to an asset until death, pass it on to his heir, and the appreciation of the value of the asset during his lifetime is never subject to income tax. That is a privilege to owners of appreciated assets under the current system.

The inflation problem is not a single problem that needs to be solved all by itself and thereby will get us to Nirvana. It is one of a series of problems, and I would be terribly upset if the Congress were to index capital gains and not deal with the problem of the deferral of tax over the lifetime of the asset and the forgiveness of tax on appreciation when assets are passed over to heirs upon death.

There are other problems with the Tax Code with respect to inflation, and if inflation accelerates substantially we may have to deal with them.

One of the most important ones has to do with depreciation of physical investment. Another has to do with the treatment of debt and interest bearing assets. Those are very difficult problems to deal with. Treasury once attempted to deal with them.

They did some very ingenious things that, unfortunately, despite their ingenuity, simply failed to go far enough and simply failed to hit the mark. That is part of the reason why, because of all sorts of practical problems that were created, that we didn't go to a completely indexed tax base at the current time.

If we have to deal with this problem in the near future, it is pretty clear to me that we are going to have to accept some imperfect solutions, I think we ought to try to deal with that issue on the most reasonable and most practical possible basis, and I think that means that some things that some people would like to do, including the indexation of debt and the indexation of interest income, might be beyond the pale. We might have to stop with the indexation of depreciation. That can be done on a fairly reasonable basis and I think that could be the first thing that we should do if we have to deal with the tax base issue.

I have probably spoken longer than I should. So let me stop, Mr. Chairman, and I am sure we are all delighted to answer your questions.

[The prepared statement of Mr. Minarik follows:]

PREPARED STATEMENT OF JOSEPH J. MINARIK

THE TAX REFORM ACT OF 1986:
IMPLICATIONS FOR THE ECONOMY AND FOR TAX POLICY

Before the Joint Economic Committee
U.S. Congress
September 12, 1986

Opinions expressed herein are the author's alone and should not be attributed to The Urban Institute, its officers, trustees, or funders.

The Tax Reform Act of 1986, if enacted by the Congress and signed by the President, will make the tax system fairer, simpler for the vast majority of taxpayers, and more efficient. Because many of the details of the bill will become available only in the next few days, this statement will deal only with the broad outlines of the bill. Nonetheless, the broad outlines are enough to trace a positive overall path for the taxpayers and the economy.

The key to fairness and economic efficiency, and to simplicity of economic choices, is taxing income from different sources on the same basis. Preferential rules benefit some taxpayers over others, wastefully steer investment into tax-favored avenues, and divert time and effort into staking legal claims to the tax breaks. The new law would repeal or cut back most of the existing tax preferences, and all of the most important ones: the exclusion for part of long-term capital gains, the investment tax credit, and the extremes of accelerated depreciation.

The so-called "passive loss limitation," though somewhat ungainly, will probably achieve the better part of its objective of ending extremes of use of tax shelters. The importance of this objective should not be underestimated. Tax shelters soak up billions of dollars of our scarce investment capital every year. Further, and in my opinion even more important, they make possible large scale and conspicuous tax avoidance. An income tax that in the public view can be bought and sold will not long stand as the pillar of this nation's revenue system. Though the passive loss limitation will complicate some taxpayers' business choices, it should on balance make the income tax system more sound.

The substantial expansions of the individual and corporate minimum taxes are further elements in the attack on conspicuous tax avoidance. Personally, I would rather that this fight had been carried on through more aggressive base broadening under the ordinary taxes than through the minimum taxes; there is no valid tax policy reason to use two taxes when one, properly designed, would do the job. Nonetheless, at least some tax on high-income individuals and profitable corporations is an essential part of tax reform, and the minimum taxes, with some unfortunate side effects, will get the job done.

In this vein, we should not forget the long-overdue tax relief for the poor and near poor. Burdening families below the poverty line with income taxes even after the largest tax cut in history was scandalous. Despite its rather prosaic nature in comparison to the economic sophistication of the issues in business taxation, tax relief for the poor may be the most important part of the bill.

Despite my reservations about the passive loss limitation provision and the heavy reliance on minimum taxes, I must agree with Senator Russell Long that the Tax Reform Act of 1986 is the best tax legislation in 36 years. It is far beyond what even the most optimistic observer would have dreamed of five years ago. It presents the Congress and the President with a rare, perhaps even unique, opportunity that the nation cannot afford to miss.

Tax Reform and the Economy

When the 1981 tax cut was passed, the most enthusiastic of its advocates predicted instant miraculous improvements in the economy. In contrast, tax reform has never been billed as an economic quick fix. Nonetheless, the continuing atmosphere of 1981, in which each monthly or quarterly economic statistic is viewed as an indicator of the success or failure of long-run policy, could submit the current tax legislation to an irrelevant test, and could even provoke an early attempt to reverse our policy course. It is important that we view the economic consequences of tax reform more realistically, and so set a reasonable policy for the long haul.

Objectives for the long run. The 1981 tax cut was sold primarily on the ground that it would increase work, savings, and investment. In fact, the merits of tax reform on this ground are similar; by reducing the tax bite out of an additional dollar of income--through lower tax rates--tax reform makes all income-producing activity more attractive. Nonetheless, at least in this country, people tend to work and save about the same amount regardless of the tax rate; reducing the tax rate elicits only a small, marginal increase in work and saving. So this effect of the 1981 tax cut was muted, and the corresponding effect of the 1986 tax reform will be similar.

The ultimate payoff of greater work effort, savings, and investment comes in faster growth of economic output and productivity; if workers work more and have more and better equipment with which to work, they can produce more goods and services, both in absolute terms and for every hour of labor. Realistically, however, not only is the tax-induced increase in work, savings, and investment relatively small, but the link between increases in investment and increases in productivity is very hard to define and demonstrate, and likely relatively weak. So again, the payoff of the 1981 tax cut has been small, and the payoff of the 1986 tax reform will likely be small as well.

In some important respects, the 1986 tax reform will constitute a significant economic improvement over the current law. The 1981 tax cut created a hodge-podge of incentives that pushed business investment in many irrational directions. That law made many investments that were totally inefficient and wasteful in a business sense into profitable undertakings after tax advantages were considered--the definition of a tax shelter. For example, some investors were driven into investments in commercial buildings that lost money in the marketplace but turned an after-tax profit--by generating disproportionately large tax losses that could reduce the tax liability on the investors' incomes from other sources. The economy has suffered as a result--witness the unfilled need for capital in some profit-making sectors, and the simultaneous overbuilding of commercial real estate. The 1986 tax law will make those tax shelters unprofitable, and so free investment capital to flow in more economically productive directions. As a subsidiary benefit, with lesser demands for credit to finance tax shelter investments (and also consumer spending), interest rates should fall, making financing cheaper for legitimate business investment.

However, both the reallocation of capital and the reduction of interest rates will have their payoff only over the long run. It will take several years for new profit-making investment projects to be planned, constructed, and put into service. And even at that point, the ultimate payoff in terms of faster economic growth and greater productivity will likely be subtle. Thus, tax reform will do everything that we can do--and therefore should do--to improve the operation of our economy through tax policy. We must be realistic, however, and recognize that the ultimate burden of competitiveness lies not with the federal government, but with the private sector. Tax reform will reduce government interference in private decisions, and so will increase growth and productivity modestly and over the long run; but those who hold their breath waiting for a spectacular impact will likely run out of air.

Tax reform and the short run. The irony of tax reform--and the danger to its survival beyond enactment--is that in the course of pursuing its long-run goals, it could make the short-run economic indicators look worse.

An example is the use of commercial structures as tax shelters. Under the current law, our economy is building commercial structures over and above what the market demands just to provide tax savings to private investors. This is wasteful; it hinders our long-term competitiveness and growth, and it must be stopped. When it is stopped, however, and before the demand for industrial and other structures increases to take up the slack, the construction industry will be slowed. Those who ignore the inevitability and the necessity of this adjustment will argue that tax reform is harmful to the economy.

This same effect will extend to the statistics on total investment--which are viewed by some as a barometer of our economic progress. Even though commercial buildings that lose money before taxes are a decrement, rather than an increment, to our economic capacity, they are included in the national accounts as investment. If wasteful construction of commercial structures were to decline, and nothing else changed in the economy, the national accounts would register a decline in investment--and some observers would declare an economic emergency. It will be vital to look beneath the surface of the national accounts to assess the impact of tax reform.

The investment statistics will be distorted further by the timing effects of the enactment of tax reform. It has been clear for some time that any tax reform bill will repeal the investment tax credit effective January 1, 1986. Every rational businessman accelerated his flexible investment plans prior to that date so that he would receive the investment credit. As of January 1, 1986, those accelerated investments had already been made. The investment statistics, therefore, show artificially inflated investment before January 1, 1986, artificially reduced investment after that date, and thus a spurious decline of investment over the entire period. It would be easy to read that spurious effect as evidence that tax reform is bad for business investment over the long run. The Chamber of Commerce has already mistakenly made that claim in a press release.

Also, it is worth pointing out that the phasing-in of changes in the law provides a very gradual transition for businesses contemplating investments in physical capital. For example, a business choosing whether to make an investment in 1986 or postpone it until later will see tax advantages to investing now; first, it can claim the generally more generous ACRS depreciation system, and second, it can claim its first year deductions against the higher current law tax rates, when the deductions will be more valuable. Later, when the choice is between 1987 and later years, 1987 will offer the tax advantage of claiming the first year deductions against a blended rate that will be higher than the permanent 34 percent level. Thus, businesses will be let down relatively easily in the withdrawal of investment incentives, with continuing inducements to invest currently rather than to postpone investment.

Ultimately, of course, we must face up to the issue of just how effective investment incentives are. We do know that the track record of the 1981 tax cuts is mixed at best, and that any subsequent increases in investment were heavily concentrated among purchases of automobiles, computers, and commercial structures--types of assets that either have little impact on productivity and competitiveness (automobiles and commercial buildings), or were not favored by the 1981 law in the first place (computers). But even beyond those points, we should recognize that the sharp reduction in the corporate tax rate makes prospectively profitable investments more attractive, and should offset most of any dampening of investment caused by repeal of the investment credit and the slowdown of depreciation. In my opinion, any investment project that is attractive under the current tax law but would not be attractive under the new tax bill would necessarily make little or no contribution to U.S. productivity and competitiveness.

In sum, the exaggerated sales pitch for the 1981 tax cut may have made us impatient, demanding a quick payoff from any economic policy. In the case of tax reform, such an impatience may lead us to miss the point of the policy and judge it on false grounds. Economic growth and competitiveness are slow-moving objectives, and are not easily amenable to manipulation by policy in any event. The impact of tax reform will be positive, but subtle and long in coming. Further, tax reform will induce some negative wiggles to our economic indicators in the short run. If we allow these spurious signals and our impatience for results to lead us to reverse our course a few months from now, we will be casting away long-term benefit for short-term gratification.

Where To From Here?

The next step, of course, is to pass the bill. Given what is nearly in our grasp, the negative comments of some Members of Congress is most disturbing.

The greatest enemies of the bill right now are misinformation and fear. Many taxpayers have been scared to death by slick media campaigns over the past two years. It is hard to compete against interests so shameless that they will substitute television images of birds eating a loaf of bread for the facts. Nonetheless, the inability of the majority of the American people to compute for themselves the net impact of a complex piece of legislation, when that net impact is undeniably positive and significant, is no valid reason to vote against the bill.

If the bill is passed, there will undoubtedly be technical corrections to be made. There will also be substantive trouble spots. The passive loss rule may be circumvented too easily; already there is advice to tax shelter owners to buy parking lots, to generate passive income that will absorb their passive real estate losses. The corporate minimum tax will also cause some problems; there will be questions about the unprecedented "book income" provision, and even the substitution of the preexisting "earnings and profits" measure in the base of the minimum tax will leave doubts and ambiguities. But tax reform is a long-term policy, and our goal should be to smooth out these rough edges--perhaps with relatively broad changes--but to leave the overall structure of the act intact to do its work for the taxpayers and the economy.

The tax system will remain vulnerable to inflation, albeit somewhat less so than in the past due to the lower statutory rates. If inflation is rekindled, we may need to look again at the tax treatment of income from capital. Perfect solutions are not available, but rapid inflation may force us to accept imperfect remedies for inflation's distorting effect on the income tax and economic decisions.

Finally, if we choose to increase taxes to reduce the budget deficit, above and beyond reasonable increases in excises on alcohol and tobacco, we must recognize that the reformed income tax is a more suitable, not a less suitable, instrument for closing the budget gap. Consumption taxes, by contrast, would add new complexity to the tax system (as any additional tax would), and would burden excessively those least able to pay. Consumption taxes to fund new investment incentives, rather than to narrow the deficit, would be even more offensive on grounds of fairness.

The Congress is near an historic advance in tax policy. With care and persistence, we can give the American people a tax system that is worthy of their trust.

Representative OBEY. All right. Thank you very much.

In the interest of time, let me put three general questions, some of which I touched on earlier, and just see if any one of you wants to respond to it in the 5 minutes I have available before other members question you.

My concerns would be these, at least the most important concerns.

Yesterday Senator Domenici raised serious doubts about the ability of the Congress to meet the Gramm-Rudman deficit targets, particularly if the tax bill was approved this year. He pointed out the kind of hole we would be digging ourselves in for next year.

I would ask how you would respond to Senator Dominici's expressed concerns of yesterday.

Second, Mr. Minarik and others have indicated that there is probably no real deleterious effect on our trade posture because of this legislation and because of other factors in the economy and in the tax bill itself, and I would like to know who agrees and who disagrees with that.

And, third, I would like to ask you again, what if we pass this bill, assuming we do, and next year at this time if we also have a continuation of the weak economy. For instance, the Labor Department indicated in the last quarter private business output actually declined. If we continue at anywhere near that pace, what do you think are the most strenuous pressures that are going to be brought to bear on the Congress next year in terms of requests people will be making on the Congress for changes in the Tax Code?

Anybody who wants to respond to any of those, please confine your responses to about a minute so we can pass down the table.

Mr. CHIMERINE. Mr. Chairman, I will take a crack at all three, and I hope I have a minute for each and not a minute in total.

Let me start with the deficit outlook and Gramm-Rudman. Quite honestly, I think 1987 will be the last year when we can get close to Gramm-Rudman targets, even in the budget projections, by using some of the methods that are now being used, whether it be optimistic assumptions, or selling off assets, or other kinds of budget manipulations.

The deficit in 1987 will be about $200 billion again. To get down to $108 billion in 1988 will be very difficult, for a couple of reasons.

First of all, the tax reform bill allegedly will lower taxes in fiscal year 1988. So it will exacerbate the deficit in that year. If it is a revenue loser over the period as a whole, it can even be more of a problem in 1988 than is now being anticipated.

Second, I think we are getting close to the end of the declines in the military spending, and we are not cutting nondefense much more.

So one of two things has to happen for 1988. Either we have to amend or scrap Gramm-Rudman-Hollings, or there are going to have to be some significant tax increases if we make a serious effort to get to the target.

Second, I think you are going to be under enormous pressure to restore the investment tax credit in the future if investment weakens further and if the economy remains very sluggish. You are going to be under enormous pressure to restore certain kinds of investment incentives to stimulate investment. You will need other revenues to pay for them if they are wanted.

To the extent that there is a need for more revenues, as there will be down the road, I very, very strongly support the view that was expressed a moment ago by Joe Minarik about doing it on the income tax side.

We have significantly reduced the progressivity of the tax structure in this country in recent years. We have shifted the distribution of the tax burden significantly away from the upper income groups to the middle and lower income groups. I think we have already gone too far in that direction and most types of consumption taxes would very likely exacerbate that problem.

I would be strongly against them for another reason. I have a wager with John Makin that we won't have a consumption tax and I would like to win that bet. [Laughter.]

So for both of these reasons I would not support raising revenues that way. I prefer doing it through the income tax structure.

Third, on trade, as I mentioned in my testimony, it is very hard to measure. I don't think tax reform will be a dominant factor, but if you ask me whether the tax reform legislation will make the trade problem better or worse 5 or 10 years from now, I would say it is more likely to make it a little bit worse than make it better.

Representative **Obey**. Does anybody else want to comment? John.

Mr. **Makin**. Thank you, Mr. Chairman.

I agree with a number of the comments, especially the ones that Larry has made about the trouble that the economy is in. However, I think that you have to ask yourself how much the tax bill has to do with the trouble the economy is in. I think very little.

The second issue is it is now September 12, 1986. The tax reform or tax revision effort has been underway actively since November 1984. I think that were the Congress to back away now and well, I think maybe we will keep this going for a while and think more about the bill, et cetera, I think the damage there in the short run would be greater than the possible damage that might result from a temporary increase in the cost of capital.

I know it is an uncomfortable feeling, but I think that having come this far and having some assurance that the bill is not a disaster I think the quicker you pass it the better.

Representative **Obey**. Mr. Galper.

Mr. **Galper**. There is no question that there is a deficit problem which will get worse in fiscal 1988, and given the softness of the economy I think one of the things you have to do is develop a new glide path for reducing the deficit over time.

If you can't get to that $108 billion target in 1988, that target may have to be revised and, indeed, there will probably have to be some tax increases, as we have already acknowledged. But I think that tax increases can be accomplished in the context of a new plan for reducing the deficit. That may be one of the consequences of this.

As far as the trade issue is concerned, I don't think the tax bill is going to do very much on that one way or the other, I agree with Joe Minarik that as far as the final prices of our goods that would be selling abroad and how they are likely to be affected by this tax bill, you are talking of price changes on the order of 1 or 2 percent given the cost of capital changes on the order of 5 or 10 percent. The extent to which that is likely to make a difference in our penetration of foreign markets or the loss of foreign markets is next to nothing and in any event swamped by currency fluctuations on a week-to-week basis.

Some of the points that Larry made on that I think go exactly in the other direction. For example, in looking at future sources of international competitiveness, is it the old line capital intensive industries that are going to be the source of that, or is it the new high technology, knowledge-intensive industries? And which of these industries is going to be most benefited by a more neutral tax system in the way that the system is now being restructured?

So I am not entirely sure that these tax changes work to the disadvantage of where our future trade patterns will be, but could very much work to the advantage of where our future competitiveness will be.

There is no question that if the economy does turn sour whether it has to do with the tax bill or not, the tax bill certainly is going to take its lumps for having been enacted before the economy turns sour. Indeed there will be pressure to restore the investment tax credit in those circumstances.

In my view, that would be a tremendous mistake. It just restores all the uncertainty as to what the system in fact is going to be like, and this on again, off again business does more to harm long-term investment planning than putting the system in place and letting it stay there for a period of time.

So I think that would be a very bad mistake to respond to every shortrun jiggle and say now we have to put this on and now we have to make it 8 percent; no, no, that is too low, let's make it 10 percent, well, back to 7. Let's just have a system that we think makes sense that is a longrun, broad-based, low-rate system, modify it with additional revenues as needed, but let's let the basic structure settle down.

Mr. MINARIK. Mr. Chairman.

Representative OBEY. Yes.

Mr. MINARIK. Harvey has inspired me to want to second a couple of things he said. Harvey raised the point about the question of the Gramm-Rudman glide path and it is a very good image.

The point here is where is the runway that you are trying to get to? Where is ground zero that you are trying to hit?

Gramm-Rudman has the assumption that a zero deficit measured in current dollars is the right place to be in 1991. I think what we have to recognize is that where we really want to be with a zero deficit is at any given time something like a zero structural deficit, the deficit that we have in the economy, if it is operating at something like a reasonable longrun stable range of employment.

I think we all agree that the economy right now is fairly well underutilized. The notion of pushing an underutilized economy to a zero deficit at any future date by some mechanical formula is a very troubling one to any economist that I know.

The difficulty here, you know, there was a need for a show of will with respect to the deficit. Gramm-Rudman responded to that. I can't argue with shows of will and I can't argue with good intentions, but somebody described it once as a bad idea whose time has come.

Maybe as we look at the deficit figures in the next few years and the implications for our economic choices we will come to recognize that. This may not be the right time to be ringing the economy in a deflationary sort of way when we are concerned that maybe this recovery is getting a little long in the tooth.

Representative **Obey**. Well, I agree with you that the right target is probably the structural deficit. The problem is that it is going to be difficult to get a consensus on that judgment as long as the Flat Earth Society is still in the majority. [Laughter.] Congressman Wylie.

Representative **Wylie**. Thank you, Mr. Chairman. This has been a most interesting and impressive panel and you have certainly stimulated the thought processes at least of this member.

I would like to ask some questions that are a little more provincial, what shows up in my mail, and see if you can help me with some answers to those.

My mail has been real heavy on this issue as to the tax benefits of IRA's and the fact that they are going to be sharply restricted, the impact on 401K's and 403B's from the college professors at Ohio State University on down. The savings rate is very low in our country, and I think the IRA has had a good impact as far as the savings rate is concerned.

What is your view and, Mr. Galper, I will start with you as to the impact these particular provisions have. As you know, the contributions are lowered for 401K's from $30,000 to $7,000? Would you just address that issue?

Mr. **Galper**. In my view, IRA's have not done anything to increase the savings rate. I think they have just given the opportunity for all kinds of game playing, for people to borrow money, deduct the interest and put the money in an IRA and earn tax-free returns; or to shift assets from one account to another, from a taxable account to a tax-free account; or at the very least save money that they would have saved anyway but use this form because it is so beneficial for them to use it.

So I really don't think that IRA's have stimulated any new saving to any substantial degree. We have aggregate evidence to go on which, as Bob McIntyre indicated earlier, does not seem to comport well with the idea that IRA's increase saving since at the same time that we have provided all these savings incentives, the aggregate saving at the household level has been declining.

So I really cannot justify them on those grounds. The question really is if we broadened the base by removing these incentives is it more effective or better policy to have the lower rates that would result as opposed to maintaining these so-called incentives and having higher rates.

My choice is clearly a broader based, lower rate system. I think that is a more efficient tax structure. So I would say that you really have to look at the tradeoffs. If we could do everything, that is fine. But the essence of this is that there are tradeoffs, and that is the way in which the argument has to be couched—in terms of both a general response and a response to individual constituents.

That is, that was one of the means by which we were able to reduce tax rates across the board.

Representative WYLIE. There was a lot of money set aside for an extended period of time which in effect are savings. Do you have a comment on that?

Mr. MAKIN. I can tell that Harvey hasn't answered any constituent mail lately. [Laughter.]

I respect his opinions and I think I agree with everything he says, although having tried to explain some of these things to individuals, that is not the way you convince folks.

As I understand it, the conference agreement permits the IRA's as they are under current law for families with incomes of—is it 50—it is phaseout between 40 and 50. So one thing you could say is well, if your income is below $40,000 you haven't lost anything.

For the higher income people you can point out that you may not have lost anything because remember what you are doing with an IRA is deferring income, and the idea is that you put it away now and you take it out when you retire.

Well, under the new bill the highest tax rate that you can have is going to be either 28 or 33 percent. So you can take out faster. Suppose under current law you took it out too fast and you would have a 50 percent rate to pay. Under the new law the highest rate you can pay is 33 percent and probably 28.

So you could take the money out faster when you retire and then reinvest it, and if you go through a lot of calculations you can show that for some people they are actually better off under the new law. But I think the way to explain it is you can get the money out of the account more quickly.

I do think that people tend to forget, you know, I put it in, it is wonderful, that you do have to pay a tax on it when you take it out, and that is the point to emphasize with the higher income constituent.

Representative WYLIE. Thank you. Mr. Minarik.

Mr. MINARIK. I don't want to compete with John Makin on stylistic points in answering constituent mail, but if I may disagree with one of your premises with all due respect, Honorable Mr. Congressman, sir. [Laughter.]

It seems to me that there are some arguments that I think I would like you to understand with respect to the IRA's that I think are very important.

One is the IRA as it currently is constituted is the opportunity to put $2,000 of your money, maybe it is your money or maybe you borrowed it, that is an obvious point, into some savings account and get a tax deduction for the $2,000 when you do it.

What you want to recognize is that there are a lot of people who are putting money into IRA's right now, the kind of people who are affected by this bill, who save routinely more than $2,000 a year.

What you do if you are in that position is you put the first $2,000 in your IRA and from there on you are on your own. If you save an additional dollar and the interest comes in, you are paying taxes on the interest on that marginal saving, and that is an economist's buzz word of course, of up to 50 percent.

I really wonder whether it is a better inducement to tell somebody that you are going to give them a break on the first $2,000 but tax them on the interest on whatever extra savings, he has up to 50 percent, as opposed to taking the current law when you can save all you want and you are not going to have to pay more than 28 percent, or 33 percent if you are in the phaseout zone.

Then there is one other question on the data. As some people used to say, the IRA is being effective in inducing people to save. Now I know I have seen some economists say, look, here are these statistics and that shows that umpty-ump thousand people with incomes of between $10,000 to $20,000 a year are putting money into IRA's.

Harvey Galper published an article not too long ago in which he made what I think is a very, very important point, and I would like to elaborate on that.

The point is that at any given income level if you look at the people who are putting money into the IRA accounts, it is disproportionately people who are receiving a lot of their income not from labor, but from interest in dividends. In other words, they have already saved a lot of money.

Now what does that imply? That implies that there are people who are simply moving money they saved before into the IRA and thereby getting a tax break. Let me give you a perfect example, if I may take a minute. My mother will be thrilled if I mention her in a congressional hearing.

Representative OBEY. No more than a minute because his time has expired.

Mr. MINARIK. His time has expired? Sorry.

Representative SCHEUER. We want to hear about your mother?

Mr. MINARIK. Oh, you want to hear about my mother. [Laughter.] Great.

Representative SCHEUER. Including your father. [Laughter.]

Mr. MINARIK. Well, my father is part of it because he left some money to my mother. My mother has a part-time job working in the local Hallmark store, and at the end of every tax year I call my mother and I tell her, Granny, take $2,000 from your regular savings account and move it over into your IRA.

And she says to me, what? What do you want me to do?

And I say, Granny, don't ask questions. Just take $2,000 from your regular account and move it over into your IRA.

She pays less tax, everybody is happy and there hasn't been a dime's worth of saving done over and above what we otherwise would have in the economy, and that is where part of your Federal deficit is.

I love my mother, but I don't think that we really need to subsidize her in a misguided attempt to increasing savings in a form of attempting to help the economy.

Representative WYLIE. You have been very helpful in answering my constituent mail, I think. [Laughter.]

Representative OBEY. Congressman Scheuer.

Representative SCHEUER. I yield to the chairman of the Joint Economic Committee.

Representative HAMILTON. That's all right. Go ahead.

Representative SCHEUER. Let me say, Mr. Chairman, this has been an extremely interesting hearing, and every single one of the five witnesses has been extraordinarily provocative and thoughtful and I am very grateful to them. It was a real privilege listening to them.

My second question about the policy options was answered. I appreciate the spanking that I got for saying does the deficit matter, but at least I invoked a response.

Mr. Minarik, I am going to ask you about those two apple barrels you spoke about. I agree with you that the real estate tax packages, of whom I used to be one in my prior reincarnation, have gone way to the bottom of the barrel and they crashed through and they were in their pebbles and the mush and the muck below the barrel. We have eliminated that and I think that is a major advance in this law.

Let's talk about the other barrel, the high-tech people, the smokestack people and maybe we should make a distinction in the treatment of them. But in any event, one thing they have in common is they are in bitter competition with overseas entrepreneurs.

Somebody mentioned Taiwan and South Korea where there is amply capital and ample high technology and ample skilled labor working at a fraction of the wages that an American is willing to work for. So that we have the most bitter kind of competition facing us if we are going to survive as a global competitor.

Now let's think about that barrel. Our smokestack industries have been very selective about the particular shinny red apples that they would pick out from only the top, and they picked out one or two and they have made the investments that you might grade as A plus, but a lot of straight A investments and an awful lot of A minus investments have gone unmade, which would be good for the American economy had they been made and would have enabled us to compete more effectively had they been made.

What do we do for that second barrel? Let's forget about the first barrel where they cleaned out every apple, including some fairly rotten ones. What do we do about the second to get them to go beneath those top few shinny apples to some of the investments that really are in the interest of our country?

And I will be happy if, after Mr. Minarik is finished, if any of you have any other thoughts.

Mr. **MINARIK**. Let me suggest, Congressman Scheuer, that there may be some limits to what we can do in this regard through the tax system, but let's look at it this way.

Larry Chimerine mentioned, and I think he is correct, that we are facing some difficulties in the smokestack sector, and I am talking about straight manufacturing kinds of businesses, relative to a lot of our competitors overseas, and in many cases the labor-cost advantage that they have is far and away in excess of the transportation costs that they have to bear to get the goods to us.

I would suggest to you that we can't use the tax system to eat away those advantages. We have to be more efficient and the choices have to be better.

I would like to mention one way in which, in my opinion, this tax system is very positive for that kind of a problem. A steel factory for example, is not just equipment. It is also buildings. If you look at the equipment in the buildings in a steel factory as different assets that have their own rate of return, you will find that the current tax system treats the buildings very harshly. It is very nice to the equipment, but the tax rates on the buildings are very harsh.

I find that to be a provocative thought in light of something that Bob Crandall at Brookings related as to some comparisons that he has made between steel factories in the United States and steel factories in Japan. He says that very often you will find steel factories in the United States and Japan that have the same equipment. The steel factories in Japan are more efficient than the steel factories in the United States, however, with the same equipment.

Why is that? The reason is that the Japanese built the factory from the ground up that was designed to accommodate the equipment it was using. You take the material in one end of the building, and they go from one stage of production to the other, and they come out the other end and they are shipped away to their markets.

You go to the American factories and you find that what happened was that an old factory was simply updated by taking out the old equipment and putting in the new equipment.

You look at how that works and you put the materials in one place and they go through one stage, and then they are taken and carried someplace else and they are put to work there, and the materials are moved around. You are using a lot of labor simply to move the material within the factory.

A lot of people argue that equipment is the only source of productivity increase. That just ain't so. The fact of the matter is that it is a joint production process that uses equipment and structures.

What this tax law has done to some degree is level the playing field between equipment and structures. I am not prepared to say that that means in a lot of these situations that businesses will decide that because buildings are not treated very equitably that we are going to use the old building and we will economize there and put new equipment in the building and thereby defeat the whole purpose.

But it is possible that we will be changing some of those decisions. That is one of the merits of the level playing field, and it is one of the important aspects I think of this piece of legislation that ought to be kept in mind when we look at the smokestack sector.

Mr. **Chimerine**. Congressman, I would agree that many of the problems we have regarding international competitiveness and productivity cannot be addressed directly by the tax system.

However, I think a lot of people still think of automobiles, steel, and maybe some shoes and textiles when they think of our trade problems. It is a much broader problem than that. There are very, very few industries that are not having some difficulties at the moment in competing internationally. So it is a very basic problem.

I mentioned earlier some of the reasons why I think this is happening, and there are a lot of others, including product quality in some cases.

There is nothing you can do from a tax standpoint, in my judgment, that is going to correct the problem. There are some things you can do that hopefully won't make it worse, and might contribute slightly toward some improvement down the road, but you can't use the tax structure to produce a trade surplus in the United States 5 years from now.

Representative OBEY. Congresswoman Fiedler.

Representative FIEDLER. Mr. Makin, you indicated that you were thinking about working on international affairs next year. Well, I will just tell you, don't put away your balance pad because you are going to need it. I have a feeling we are going to be talking taxes next year and the year beyond that as well.

Mr. Minarik, you said income taxes will become the best vehicle for raising taxes. I must say to you at least from my philosophy, that would be the best reason in the world for me to vote no on this tax bill. I can also assure you that there are at least 50 to 75 other Members that I can think of very quickly who would feel the same way, if they felt that by passing this tax bill we simply devised an efficient system for raising taxes in future years; that we would as a bloc vote enthusiastically and work hard to see that this tax bill was defeated.

I am very concerned about that aspect of tax reform, that the feasibility of using it as a step toward tax increases would be the ultimate purpose given the revenue neutrality of the existing bill.

Each one of you mentioned the possibility of a tax increase, some with specific ideas about ways in which taxes could be increased. But I just want to remind you of a fact, and that is in the last 53 years there have been 193 tax increases. Forty-five of those years we have been in deficit, and never once when taxes have been increased have we used it to reduce the deficit.

So I think there is some faulty thinking going on or false assumptions going on when you talk about raising taxes as a means by which to reduce our deficit; because historically in these bodies all we have seen is excuses for tax increases.

Mr. Chimerine, yours, in my opinion, was a different viewpoint, one that was very business oriented and one that pointed to some issues which were somewhat different than some of the others that were raised, and because of that I would like to ask you a question.

I would like to ask you what you think the implication for the passage of this bill will be in the short run on jobs, because I am quite concerned about people.

If you talk about tax reform in a very global and general sense, you lose what you think it might be on jobs.

Mr. CHIMERINE. Well, potentially I think there are two effects. First, if the economy does slow further, and if part of that slowing reflects the impact of the tax reform legislation, that would have a negative effect on new job availability and on labor markets in general in the short term.

On the other side, to the extent we are raising the cost of capital, this will provide an incentive for new jobs as a substitute for new capital. So you are going to get these two effects, and my guess is it could potentially mean somewhat higher unemployment when you net these two out in the short term, if I am right that the economy will stay sluggish and the tax reform legislation will make it somewhat worse.

May I just make a quick comment on your other point about raising taxes. The one thing I think both this Congress and the administration has done is stopped the proliferation of new spending programs, stopped the growth in spending.

It is hard for me to accept the argument any more than any tax increases or new tax revenues are going to be used to finance new spending programs. I think that has been stopped. That process started a few years ago, probably under the Carter administration. It has been accelerated in recent years. I think the environment is very different from that standpoint than it was 10 to 20 years ago.

Representative FIEDLER. I think it is better, but I think that we are still seeing a substantial amount of increases in spending, and that is also one of the points that I noted in listening to your presentation is that with the exception of your presentation nobody else mentioned the feasibility of containing spending. Everybody else was focusing in for the most part on the idea of raising taxes.

I had one other quick question. Given the fact that the bell has rung, I would like to go to it very quickly, if I can.

Mr. McIntyre, I would just like to ask you, if I may, what do you think is going to be the impact of this bill on the underground economy? You seemed to have a very positive view of the fact that we were going to be cutting down on the number of people who were cheating or not paying on taxes. What do you think the impact will be on the underground economy?

Mr. McINTYRE. Well, the direct impact of reforming a system that now allows so many people to legally avoid taxes is probably in the long run to curb the growth of the underground economy. It is hard to tell how much. There have been a few studies done of what impact there is on tax cheating by people losing faith in the system, and they have shown that in fact there is a correlation between a belief that the system is unfair and people stopping paying their taxes honestly.

So if I am right that this bill is going to rekindle public support for the tax system, I think probably you will see that some people who might have turned to cheating may decide not to.

Representative FIEDLER. Thank you.

Representative OBEY. Thank you. The bells are about to ring for second votes. Let me ask if we break, they are ringing right now, will Members be coming back to ask questions?

You will, Marcy?

Representative KAPTUR. [Nodding affirmatively.]

Representative OBEY. OK. We will be back in about 7 to 8 minutes, I hope, if you can all stay.

Mr. MAKIN. Mr. Chairman, I am going to have to leave. I'm sorry.

Representative OBEY. All right. Well, I thank you for coming, John. I appreciate it very much. You have added considerably to our discussions today. We will be back in just a few moments.

[A brief recess was taken.]

Representative OBEY. I'm sorry this is running so late. I appreciate the fact that a couple of you could stay. Congresswoman Kaptur has several questions.

Representative KAPTUR. Thank you, Mr. Chairman, very much. I just wanted to ask if any of the witnesses would wish to comment a bit more on the statement that Mr. Chimerine, who is no longer here, made regarding that tax reform would increase the cost of capital by 10 percent and that would not be offset by the reduction in interest rates.

I know I have talked to some of the businesses in my district and some have said that they calculated it and they think they come out all right.

What are your assumptions on interest rates? I understand, Mr. Galper, that you might have said something about that in your testimony that I wasn't here for.

Mr. Galper. No, I didn't talk about that directly, but I can try to respond to that. I think 10 percent is on the high side of the numbers that I have seen for increases in the cost of capital, point one.

But, point two, I think you do have quite different impacts across industries, that is the extent to which the rate cuts compensate for the loss of the investment tax credit or for changes in the depreciation rules, it depends a lot on the mix of assets that you use in the industry and also how capital intensive the industry is.

So some sectors, such as softer goods manufacturing, retail trade, finance, et cetera, come out very favorably. Heavy manufacturing is probably hit the hardest and you may have in between industries like electronics and aviation where it is pretty much of a wash.

A lot of it really will depend on the particular mix of types of capital and how capital intensive the industry is.

Larry can probably respond to that more directly in terms of the assumptions he has made about interest rates, but there is some decline in interest rates that I would expect to come from this legislation that would tend to move in an offsetting direction.

I don't think it will offset completely in the aggregate, although for certain industries, as I have indicated, who already find that the rate cuts are a compensation, any further declines in interest rates are going to give them a net benefit.

The other thing——

Representative Kaptur. Do you expect interest rates to go down?

Mr. Galper. I expect interest rates will fall from this legislation. I don't know how much, maybe I would say half a point perhaps.

Representative Kaptur. Mr. Chimerine, I was just asking in regard to your statement that tax reform would increase the cost of capital by about 10 percent and that wouldn't be offset by the reduction in interest rates.

I come from a heavy manufacturing and agricultural region of the country in northwest Ohio——

Mr. Chimerine. I am sorry to hear that. [Laughter.]

Representative Kaptur. Well, I haven't decided how I am voting on this bill yet in spite of all the good things people have said here. I have talked to some of my manufacturers who have calculated it out and have said that in fact it is a wash for them, and I guess I was interested in your calculation and how you——

Mr. Chimerine. Well, it will vary to some extent. There is no question, as I think Harvey was suggesting, that the largest increase in the cost of capital will be for structures, reflecting the change in depreciation. It will also rise for equipment. So the 10 percent was more of an average.

Second, I don't know how much of a decline in interest rates will occur. I still can't figure out why long-term interest rates have been rising in the last few days, let alone how much decline we may get from the legislation.

My best guess is there will be some, probably by rough order of magnitude that Harvey mentioned. So on a net basis you are still increasing the cost of capital on average as a result of this legislation.

But I agree with you, that even some manufacturing companies won't notice the increase, while others will see a fairly large increase. Again, I don't want to overexaggerate how much effect this will have. There are a lot of factors that affect investment other than the cost of capital, average tax rates and interest rates. Expected demand is probably a more critical factor.

So I am not suggesting that this is going to cause a collapse in manufacturing or a collapse in capital spending. It will just be another factor that could potentially make it a little bit worse at the margin and that is all I was suggesting.

Representative **Kaptur**. I would also like to ask any of the witnesses that want to comment, what are some of the most egregious sections of the bill, and what are the things that we don't know about yet, oil industry benefits are the kinds of things that make the headlines? What is hidden away and who got taken care of in there?

I know people in my area of the country won't be, but what are some of the more striking abuses that you have noted? There must be many. It is a pretty long bill.

Mr. **Chimerine**. Well, while I have the microphone, I will make a quick response and then turn it over to Joe.

I haven't seen the list of these so-called transition rules, but quite frankly I would suggest that a lot of them are unnecessary except from a political standpoint. From an economic standpoint, it is hard to see any real economic benefit from them. I couldn't single out one specifically, however.

Mr. **Minarik**. Interpreting that question just a little bit differently maybe than even you intended, my own concern in terms of things that they should have done in the tax bill that they didn't do are not necessarily things that everybody is going to jump up and down with glee on, but I think the two most neglected areas of the tax bill are, No. 1, fringe benefits, which continue to be largely without tax and, No. 2, the issuance of private purpose State and local bonds, which has been restrained only modestly in the face of a tremendous explosion in their issuance, which has caused a lot of trouble in the market for traditional purpose municipal bonds.

Representative **Kaptur**. Thank you. Thank you, Mr. Chairman.

Representative **Obey**. Congressman Archer.

Representative **Archer**. Thank you, Mr. Chairman. I was hoping that all five of you would still be here because I wanted to ask you a couple of broad questions and, if there is enough time, get more in depth.

There was a communication put on the desks of all of the Republican Congressmen this morning from the House Republican Conference, "Special Report, Tax Bill Increases Incentives, Lowers Cost of Capital and Improves Incentives." That seems a little redundant, but that is the headline.

Then in caps, "Executive Summary—Conference Tax Bill Will Be Good for Labor and Capital."

First, cost of capital for corporate businesses would go down by 7 to 8 percent. Cost of equipment investment will fall by 7 to 8 percent. Cost of investment in structures falls by 12 percent. GNP will be 3 percent higher in 5 years. Tax revenues will be $40 billion higher due to higher growth.

I would like, if I could, to get a response from each of you as to whether you agree with that, and if you don't agree with it, whether you think it will be more or less than this publication announces?

Did you get those items out?

Representative OBEY. Could we frame those so we can go back and look at them in 5 years? [Laughter.]

Representative ARCHER. I intend to do that, Mr. Chairman.

Mr. MINARIK. They came through brassy and clear, sir. I like the tax bill, but I find that a bit expansive. There are lot of ways to compute cost of capital figures. There may be some way to get that result. I don't know of it right now.

In terms of the anticipated increment to GNP growth, would that it were ture, I imagine that if somebody told me 3 percent higher in 50 years, I would say it is an eminently worthwhile thing to do and we ought to do it and that is a reasonable number. Three percent higher in 5 years I think is a bit much.

Mr. CHIMERINE. Without having seen that before, I will make a guess that——

Representative ARCHER. I didn't see it until this morning.

Mr. CHIMERINE. I won't even guess where they came from. I have no idea where they came from.

Representative ARCHER. Well, I'll tell you where they came from. They came from Jack Kemp. Jack Kemp is the chairman of the Republican Conference.

Mr. CHIMERINE. But where did he get the estimates?

Representative ARCHER. Well, I can tell you where they came from.

Mr. CHIMERINE. That would be interesting.

Representative ARCHER. But you have to dig back here a few pages. They came from a Gary Robbins, Fiscal Associates.

Mr. CHIMERINE. Well, I don't know what assumptions were made and, as Joe pointed out, you know, if you make the right kind of assumptions you can get any result you want.

All I can say that I find absolutely no evidence whatsoever that the changes in marginal tax rates or the other changes in this legislation can stimulate the economy to that extent over the next 5 years.

As I said earlier, I think, if anything, the risks are marginally on the down side, and without knowing more about the specifics of the study and what assumptions were made, it is very hard to comment further, but I would question them very closely.

Representative ARCHER. Harvey.

Mr. GALPER. I don't have a lot to add to that. I think you can claim over much for tax legislation. People do respond to other things besides taxes in the economy, and I don't think you want to take the extreme view, and that is the reduction in marginal tax rates drives the world.

I think it is important and I think the legislation is good legislation, but I don't think we should fool ourselves into thinking it is the second American Revolution.

Representative **Archer**. OK. Let me just follow up by saying if you had to make a guess, and I understand the uncertainties in this complex bill are so great that it is very, very difficult to quantify anything that is going to happen in the future, but if you had to make a guess, would you guess that in the short term, and I mean over the next 2 years only, would you guess that this bill would be positive or negative on real GNP if you look at it by itself without trying to anticipate what interest rates are going to be or what inflation is going to be and all those things, but solely as a result of this bill and no other factors. Would you anticipate that it is going to be, in your opinion, or have a greater chance of being negative or positive in the short term in the next few years?

Mr. **Galper**. I think it would be pretty much a wash quite frankly. I mean if you just look at the first 2-year revenue effects you have what, a minus 10 and a plus 10 or something like that.

Representative **Archer**. So you think it is a wash.

Now time is so important here, if you don't mind, and I don't want to cut you off.

Mr. **Chimerine**. A modest negative for economic growth, but economic growth is not the only thing in the world either.

Representative **Archer**. OK.

Mr. **Minarik**. Well, I am with Harvey, and I would just point out to you that when you say hold everything constant, what does that mean? Does that mean that the monetary policy is handcuffed and——

Representative **Archer**. But we can't anticipate all those things. The only thing we are dealing with here is the Tax Code.

Mr. **Minarik**. Sure.

Representative **Archer**. You would say a wash basically?

Mr. **Minarik**. I would say basically a wash and I think the other policy——

Representative **Archer**. Now let me ask you this—and, Mr. Chairman, if you don't mind indulging me, my time technically has expired——

Representative **Obey**. If we can hold it for about 2 minutes because people have to go other places.

Representative **Archer**. OK. How would you rate the accuracy of the estimates on revenue from this bill, without any great in-depth discussion of why, but how would you rate them? Would you rate them within a plus or 5 percent range compared to the current law, plus or minus 5 percent range, or would the margin of error potentially be greater than that?

Mr. **Minarik**. I don't think the margin of error is greater than 5 percent.

Representative **Archer**. Plus or minus 5 percent, OK. Are you concerned about the fiscal and budgetary impact of this bill? Do any of you have any concern about that?

Mr. **Galper**. Well, I am concerned about the fact that we are not raising sufficient revenues, and there may be an outcome where the revenues that are anticipated from this bill may not be realized which could make the problem worse.

Representative ARCHER. Do you think that the revenues will be minus rather than plus if you had to make a judgment?

Mr. GALPER. Probably somewhat greater, yes.

Representative ARCHER. Would the rest of you agree?

Mr. CHIMERINE. I would agree with that conclusion.

Representative ARCHER. OK. Now the revenue estimates that I have seen, Harvey, are that it will raise $11 billion more in 1987 and lose $17 billion in 1988. Now that is a combination of $28 billion difference when we go into trying to implement Gramm-Rudman a year from now. We have to find $28 billion just to get back to scratch, so to speak, in the vernacular, and then we have to find the extra savings to reach the Gramm-Rudman targets. Does that bother you?

Mr. GALPER. Yes, I think that this does complicate the Gramm-Rudman targets, the realization of them.

But one question is, which is a question that is really implicit in what Larry was saying, is whether those targets themselves are realistic given the state of the economy.

Representative ARCHER. But forget about Gramm-Rudman. Does it bother you in the absence of Gramm-Rudman?

Mr. GALPER. I am bothered by the fact that we need some mechanism to reduce the deficit over time, and so something like Gramm-Rudman is needed. If we didn't have a budget problem, swings of that magnitude from year to year, per se, would not be a problem.

Mr. MINARIK. As a percentage of the economy, that is nothing. So if it weren't for the fact that you had some target you were trying to hit and hitting that target was going to cause you to do something——

Representative ARCHER. It doesn't really trouble you then.

Mr. GALPER. Not per se, but as complicating the problem of reducing the deficit, then we have to deal with that.

Mr. CHIMERINE. It bothers me, Congresman, in two ways. No. 1, in the way that Harvey is describing, that we are not making any contribution toward lowering long-term deficits and, second, it would bother me enormously if we maintained Gramm-Rudman. I think we have to reduce future deficits, but not as much or as rapidly as Gramm-Rudman requires. If we keep current targets in place, and then complicate the problem by subtracting the additional revenues from tax reform for 1988 and still try to meet the current Gramm-Rudman target for that year, and do it on a realistic basis, the amount of budget cuts needed would be absolutely enormous. That would kill the effectiveness of programs and probably push us into a recession.

Representative ARCHER. Do you believe that the cash-flow of corporations will be reduced as a result of this bill?

Mr. CHIMERINE. Overall, yes.

Representative ARCHER. All three of you agree with that?

[Witnesses nodding affirmatively.]

Representative ARCHER. What happens when there is a cash-flow shortage or reduction, I should say, in corporate activities? Don't you have to either reduce investment or increase borrowing?

Mr. GALPER. Or use equity finance or cut back on other expenses.

Representative ARCHER. Well where is the equity finance going to come from other than foreigners?

Mr. GALPER. There could be a switch from debt to equity finance.

Representative ARCHER. Assuming that the entrepreneur is there. Does it bother any of you that this bill is designed in virtually an effort to emulate the Mexican tax code that they have had for the last 30 years?

Representative OBEY. Last question.

Representative ARCHER. And I don't know if you are aware of that, but Mexico for 30 years has operated on the basis of compartmentalizing all of their various types of activities and structures within the tax code so that you could not use losses from one against another, and in some instances could not deduct losses at all, and this bill does that. Does that bother you economically as far as the exchange of capital investments and the type of potential dislocations that that may bring about economically?

I have jokingly said, you know, if you like the Mexican economy then maybe you'll like this new tax bill. Obviously that is hyperbole.

Mr. MINARIK. Let me just say that I was going to say that you are superimposing that kind of a system on a very different economy.

Representative ARCHER. Sure you are.

Mr. MINARIK. Let me make another point. There are a number of economists I know of who tell us that we ought to expense physical investment and then you could come back at them in the same way and say that is exactly what Great Britain did through all the years of its decline.

Representative ARCHER. But in general though the compartmentalizing of things, and I shouldn't have brought up Mexico because it isn't really relative, but the compartmentalizing is something we have never done before in this country, and I wonder if you think there are any risks in that?

Mr. MINARIK. Well, it is only restricted to a certain class of investments, which is unincorporated investments that are of a passive nature. It is not as though you are saying that General Motors cannot take a temporary loss in its computer division against its automobile division. So this is a very narrow provision in its application. It is not going to affect the whole economy.

Representative ARCHER. No, that's true, but it also makes the corporate managers have to face a two-track tax system which it seems to me is going to complicate their decisionmaking over the long term incredible and it is going to create a degree of uncertainty which in my opinion is, and I would like to get your counsel on it, would be negative on investments because there will be a tendency to hold back without a knowledge of certainty as to what the tax impact is going to be of their decisions as a result of this new two-track tax system which they have not had to be concerned about before within the corporate structure.

Mr. GALPER. That is a separate issue from the passive loss situation.

Representative ARCHER. Sure.

Mr. GALPER. I am not a fan of the minimum tax, but you really have to say compared to what. The point is that there is this uncertainty because of the two-track system. But clearly that is a compromise between taxing those investments in full under the regular tax and giving them the preferences they now have. Their marginal rate is 20 percent, which is still a better marginal rate than the 34 percent if you are on the minimum tax. Can we think of a better approach? I would prefer to see the income which is now included in the minimum tax made subject to ordinary tax and do away with the minimum tax. But see how many votes you get for that.

So it is clear that it is a compromise, and as any compromise it has these messy loose ends.

Representative **ARCHER**. Thank you. Thank you, Mr. Chairman.

Representative **OBEY**. Let me thank both of you for your contributions. They are not normally members of this committee, but I did invite other members to come by who were curious. I am glad two were. [Laughter.] I assume everybody else understands the bill totally.

I guess what you are saying is that, if I could sum up very briefly, is that horizontal equity is increased in the bill, and vertical equity, there is some debate about. Certainly it is a little tough to suggest that the marginal rate hump creates greater vertical equity. That bothers me a lot because I think that is the next big thing we are going to have to be explaining if we pass this bill.

You are split about what comes next and there seems to be, with the possible exception of Mr. Chimerine, somewhat less concern about the impact on our trade posture from this panel than I expected to hear this morning I guess.

I don't know whether that same trend will continue on Monday. On Monday we have Alan Greenspan, Roger Brinner, Lawrence Summers, Jerry Jasinowski, Bob Eisner, and David Cooke from FDIC. So we will look forward to hearing them.

I thank you gentlemen for coming today. I appreciate it.

[Whereupon, at 12:50 p.m., the committee recessed, to reconvene at 10 a.m., Monday, September 15, 1986.]

THE TAX REFORM ACT OF 1986: IMPLICATIONS FOR THE FUTURE

MONDAY, SEPTEMBER 15, 1986

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to recess, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey, Hawkins, and Archer.

Also present: Stephen Quick, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative Obey. If we could get started, last Friday the committee held a hearing to obtain the views of a number of economists on a number of aspects of the tax bill which is wending its way through its final steps in the Congress.

I said last week that it was wending its way with undeliberate speed. That speed seems to have slowed just a trifle. But nonetheless, I think it's fair to say that when individual members vote on it they will be lucky if they have had a written copy of the legislative language for 3 days.

Having seen on several occasions before the Congress gleefully pass legislation and read it afterward, I think it's safe to say that most Members would prefer to have more time to examine a lot of the details of the bill or at least allow their staffs to examine them.

We can't obviously get into some of the details of language which will not yet be written and, frankly, a lot of that language would fall outside of the purview of this committee. But this committee's responsibility is to try to ascertain what the economic effects of that legislation are likely to be, good or bad.

I have assumed, as one Member, that I would very likely be voting for the legislation that emerged because there's a good deal in it that I would like to see happen. But there are some substantial questions that we need to hear some comments about, I think, before we make a final judgment.

I think it's safe to say that with the panel that appeared before the committee on Friday there was general support for it, ranging from the enthusiastic to the tepid; and I would say that at least one, possibly two witnesses yesterday indicated that they had minimum high regard for the tax bill. They were for it but perhaps just barely.

It's certainly apparent that it's going to pass. I think the question is simply the margin. But what I would like to ask the gentlemen before us to address this morning are questions such as these:

I think it's difficult—and these are the same questions we raised in the last hearing—I know it's very difficult with any degree of accuracy at all to provide even a reasonable guesstimate about what revenues are going to be under the legislation, both in the transition years and once it finally goes into effect. Nonetheless, we do have to ask how solid people feel those revenue estimates are because Gramm-Rudman raises certain implications about what the Congress would be required to do if those revenue estimates were off by, say, $10 or $20 billion.

So the question is, How strongly do we feel that that bill is in fact revenue neutral? Second, what are your judgments about the effect that that bill might have on our competitive posture internationally? Given the repeal of the investment tax credit, for instance, there's a significant degree of concern being expressed by some people that a few years from now we might very well find ourselves in a position where we are relying more on imported goods than we are today because of that feature. Others say, no, that that's not likely because other aspects of the bill will make it more efficient and because of the corporate tax rate reductions it will be no worse than a wash.

We have the third question of the basic equity of the rate structure with what I would consider to be the unfortunate hump which is built into it, and I think most importantly, from a legislator's standpoint, if we pass this bill, what kinds of pressures are we likely to be faced with next year at this time, 2 years from now, in terms of changes that people are likely to be asking for in the Tax Code.

I think a lot of people would like to see it just stand still for a while so we get a breather, so we don't go through this constant jackrabbit action of changing the Tax Code every 2½ seconds.

Those are the basic questions that we have today. Lest anyone is curious about why Congressman Archer, who's not a member of this committee, has just walked in, it's simply because I extended an invitation to any other Member of the House who would like to hear either of these panels to participate. And I'm glad that at least one took me up on it. Two did on Friday.

We have before us today Mr. Alan Greenspan from Townsend-Greenspan & Co.; Roger Brinner, Data Resources, Inc.; Lawrence Summers, Harvard University; Jerry Jasinowski, National Association of Manufacturers; Bob Eisner, Northwestern University; and David Cooke, Federal Deposit Insurance Corporation.

Before we begin, I should ask you, Bob, how your book sale is going? I know you're selling a book. Believe it or not, I'm about to be selling an album. You write about economics. I play bluegrass music.

Mr. EISNER. I appreciate your mentioning it. That's very important to the sales. "How Real Is the Federal Deficit?" [Laughter.]

Representative OBEY. Well, I hope your sales are going better than I expect ours to go.

Why don't we start with you, Mr. Greenspan, and why don't you just tell us whatever you want to tell us.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

Mr. GREENSPAN. Thank you, Mr. Chairman. I appreciate this opportunity to comment on the economic implications of the Tax Reform Act of 1986. My suspicion is that we are all less capable than we will be in retrospect 2 years from today. Unfortunately, I don't have my testimony that presumably will be written 2 years from today but I'll do the best I can.

In the long run, the conversion of tax subsidies into corporate tax rate reductions is likely to result in a more efficient economy. Unsubsidized capital investment at the margin should be significantly more productive than investment which must be subsidized through tax preferences.

In the short run, however, while the type of capital investment—the elimination of the investment tax credit will curtail—may not be the most productive, those investments do nonetheless create jobs and influence economic activity. Thus, we can expect for the period immediately ahead a lower level of capital investment under the new law than would have prevailed under the existing code.

Moreover, the very stiff minimum tax for both individuals and corporations will require a number of taxpayers to evaluate continuously the tax implications of every major business decision from two perspectives; that of the regular tax system; and that of the minimum tax system. This will make capital investment and other key business decisions more uncertain than under existing tax law.

With the economy currently in a lethargic stupor, additional tax reform negatives clearly raise the risks to economic growth. I am not suggesting that we should have awaited until a more propitious time. The time for tax reform is probably now or never, but we should understand that we are moving into unexplored and probably risky territory. Even though we can be confident that removing tax subsidies from the capital investment process will improve the efficiency of the economy and ultimately the level of output in the long run, the bill is so complex that there almost certainly will be some extraordinarily unanticipated impacts.

The number and magnitude of the changes in the tax bill are too great to be evaluated easily by our existing macroeconometric models. Nonetheless, matching as best we can pluses and minuses suggests that the shortrun impact of the tax bill on the economy will be mildly negative. It is difficult to be more precise since in this tax bill we must deal not only with changes in cash-flows and changes in after-tax incomes and changes in incentives created by the new tax structure and broadened tax base, but also with the very substantial changes in the market value of assets which are likely to occur as a consequence of the bill.

Just as farm subsidies are capitalized in the market value of farm land, so are tax subsidies capitalized in the value of all forms of property. In this sense, real estate market values have been higher than otherwise they would have been without the tax preferences currently in the code and their removal eventually will bring down the value of real estate relative to other assets. For example, commercial real estate construction is likely to be hurt more than one would assume based strictly on the changes in the prospective cash-flows and rates of return under the new tax regime. The expectation of declining property values could, for a while, induce a contraction in activity even greater than the cash-flows themselves would suggest. There also may be some moderate upward pressure on commercial and residential rents as a consequence of that.

The major adverse impact of the tax bill, as many have noted, is likely to be in manufacturing industries which already have been depressed significantly by high interest rates and import competition.

There surely also will be many impacts, both intended and otherwise, which will not, in and of themselves, have a significantly visible impact on the economy overall.

The abolition of the General Utilities Doctrine almost surely will reduce the number of mergers and acquisitions. The ability of an acquiring company to mark up purchased assets and then depreciate them from the higher base creates a substantial incentive to merge. This ability will be sharply curtailed in the new Tax Code. Leveraged buyouts are also likely to be suppressed. Lower corporate tax rates will make the substitution of debt for equity, which is the core of a leveraged buy-out, much less attractive. Considering today's high fixed cost environment, suppressing the conversion of equity to debt is highly desirable.

Finally, I would like to add a comment concerning the supposed revenue neutrality of this bill. A key to these estimates is that the $130-odd billion gain contemplated from the elimination of the investment tax credit over the next 5 years is very closely matched by the expected reduction in corporate tax receipts from reducing the marginal rate from 46 to 34 percent. The impact of those tax changes, at current levels of investment and profit, is approximately $25 to $27 billion per year in additional revenue from the elimination of the investment tax credit offset by a comparable revenue reduction from the lower marginal tax rate.

The investment tax credit impact reflects approximately 9 percent of the current $300 billion in annual outlays for producers durable equipment, while the tax rate change impact reflects about 12 percent of the current $220 billion in pretax corporate domestic earnings. Actually, it's a little more complex than that because deficit corporations don't have the full impact of this tax reduction.

Prior to the early 1980's, however, producers' durable equipment outlays were uniformly below pretax corporate domestic earnings and could conceivably return to that level. If, for example, producers' durable equipment fell from its current level of somewhat more than 30 percent above domestic pretax earnings to 25 percent below those earnings, a relationship which existed in the 1970's, the new tax bill would produce approximately $10 billion less revenue annually than current law, or a $50 billion shortfall over 5 years.

I don't say that this will necessarily happen. I am merely indicating how extraordinarily tentative revenue estimates are when, in effect, we are making changes in tax rates and other provisions with a cumulative impact, positive and negative, of nearly $1 trillion over the next 5 years. I would consider any analyst who came within $10 billion a year of the correct revenue differential to be either very lucky, deserving of an award, or both.

There almost surely will be a significant number of unintended impacts from this bill. Perhaps 10 to 20 important mistakes will appear in retrospect. We will not know what they are, however, until after the bill is enacted and the problems surface. Hence, a much easier forecast than what the tax bill will do to the economy is what it will do to congressional debate. As a consequence of the Tax Reform Act of 1986, there will be more tax reform bills, one in 1987 and, perhaps, another in 1988 as well. I trust that by the time the long term arrives—that is, the time when the strongly positive impacts of the current bill have become effective—the structure of marginal tax rates still will be close to the ones on which you are about to vote. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Greenspan follows:]

PREPARED STATEMENT OF ALAN GREENSPAN*

Comments on the Tax Reform Act of 1986 (H.R.3838)

In the long run, a conversion of tax subsidies into a corporate rate reduction is likely to result in a more efficient economy. Unsubsidized capital investment, at the margin, should be significantly more productive than investment which must be subsidized through tax preferences. There is a close correlation between the pretax earnings generated from a facility and its productivity. In fact, the real rate of return on a facility tends to be determined largely by improved labor productivity and/or increased capacity. If all investments were made on the basis of pretax earnings, with depreciation reflecting true economic wear and tear, then capital would be directed toward those investments which have the highest marginal productivity.

An investment whose pretax rate of return is otherwise too low can become profitable for an individual company, of course, if lower taxes boost its after-tax rate of return. The investment tax credit has been an effective means of inducing business to invest in capital equipment when that equipment failed to meet the test of pretax rate of return on an unsubsidized basis. If a pretax rate of return is above the cost of capital, investments will be made with or without the I.T.C. Even investments which are initiated solely because of the investment tax credit, however, usually create some increase in productivity or capacity. The issue generally is that they produce less than projects which meet the required cost of capital and, in the long run, investment which does not earn the cost of capital on a pretax basis is a misuse of resources and a potential restraint on economic growth.

In the short run, however, while the type of capital investments the elimination of the investment tax credit will curtail may not be the most productive, those investments do, nonetheless, create jobs and influence economic activity. Thus we can expect, for the period immediately ahead, a lower level of capital investment under the new law than would have prevailed under the existing code. Moreover, the very stiff minimum tax for both individuals and corporations will require a large number of taxpayers to evaluate continuously the tax implications of every major business decision from two perspectives, that of the regular tax system and that of the minimum tax system. This will make capital investment and other key business decisions more uncertain than under existing tax law.

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*Dr. Alan Greenspan is President of Townsend-Greenspan & Co., Inc.

With the economy currently in a lethargic stupor, additional tax reform negatives clearly raise the risks to economic growth. I am not suggesting that we should have awaited a more propitious time. The time for tax reform is probably now or never, but we should understand that we are moving into unexplored, and probably risky, territory. Even though we can be confident that removing tax subsidies from the capital investment process will improve the efficiency of the economy and ultimately the level of output in the long run, the bill is so complex, that there almost certainly will be some extraordinary unanticipated impacts.

The number and magnitude of the changes in the tax bill are too great to be evaluated easily by our existing macroeconomic models. Macromodels can evaluate effectively only changes made at the margin, that is, small tax changes and/or small expenditure changes. Policy innovations which create abrupt changes in the incentive structure, which the bill surely would do, present far more difficult analytical problems. By design, macromodels endeavor to reflect the near-term implications of the most recent past. The immediate future under this proposed new tax regime, however, would be substantially different from the economic and mathematical conditions upon which these models are based. That makes it difficult to get anything but a judgment of gross impact. Matching plusses and minuses as best we can suggests that the short-term impact of the tax bill on the economy will be mildly negative. It is difficult to be more precise since in this tax bill we must deal not only with changes in cash flows, changes in after-tax incomes, and changes in incentives created by the new rate structure and broadened tax base, but also with the very substantial changes in the market value of assets which are likely to occur as a consequence of the bill.

Just as farm subsidies are capitalized in the market value of farm land, so are tax subsidies capitalized in the value of all forms of property. In this sense, real estate market values have been higher than they otherwise would have been without the tax preferences currently in the Code, and their removal eventually will bring down the value of real estate relative to other assets. For example, commercial real estate construction is likely to be hurt more than one would assume based strictly on the change in the prospective cash flows and rates of return under the new tax regime. The expectation of declining property values could, for awhile, induce a contraction in activity even greater than the cash flows themselves would suggest. There also may be some modest upward pressure on commercial and residential rents, although new owners coming in at lower property values, and hence less equity requirements, would enjoy a benefit which partially offset the loss of tax benefits and would limit the upward pressure on rents.

The major adverse impact of the tax bill is likely to be in manufacturing industries which already have been depressed significantly by high interest rates and import competition. The average increase in corporate taxation under the bill is far greater for these groups, which depend heavily on the investment tax credit, than for the more service related or high tech industries. Effective tax rates for many companies would rise rather substantially. These include companies which have purchased through safe harbor leasing provisions, tax credits to lower their effective tax rates, as well as companies with low pretax operating earnings and large capital investments.

There surely also will be many impacts, both intended and otherwise, which will not, in and of themselves, have a significantly visible impact on the economy overall.

The abolition of the General Utilities Doctrine almost surely will reduce the number of mergers and acquisitions. The ability of an acquiring company to mark up purchased assets and then depreciate from the higher base creates a substantial incentive for mergers. This ability will be sharply curtailed in the new tax code. Leveraged buy outs also are likely to be suppressed. Lower corporate tax rates will make the substitution of debt for equity, which is the core of a leveraged buy out, much less attractive. Considering today's high fixed cost environment, suppressing the conversion of equity to debt is highly desirable.

The view that the sharp increase in corporate taxation will be passed through to the general price level is probably correct in the longer term, although the order of magnitude is small. In the short run, however, heavy competitive pressures from abroad almost surely will hold prices in check and require, in effect, that the increased corporate tax load be temporarily absorbed in lower profit margins for those companies immediately affected.

Finally, I would like to add a comment concerning the supposed revenue neutrality of this bill. A key to these estimates is that the $130 billion gain contemplated from the elimination of the investment tax credit over the next five years is very closely matched by the expected reduction in corporate tax receipts from reducing the marginal rate from 46% to 34%. The impact of those tax changes, at current levels of investment and profit, is approximately $27 billion per year in additional revenue from elimination of the I.T.C. offset by a comparable revenue reduction from the lower marginal corporate tax rate. The I.T.C. impact reflects approximately 9% of the current $300 billion in annual outlays for producers durable equipment, while the rate change impact reflects about 12% of the current $220 billion in pretax corporate domestic earnings. Prior to the early 1980s, however, producers durable equipment outlays were uniformly below pretax corporate domestic earnings and could conceivably return to that level. If, for example, producers durable equipment fell from its current level of somewhat more than 30% above domestic pretax earnings to 25% below those earnings, a relationship which existed in the 1970's, the new tax bill would produce approximately $10 billion less revenue annually than current law, or a $50 billion short fall over five years.

I don't say that this necessarily will happen. I merely am indicating how extraordinarily tentative revenue estimates are when, in effect, we are making changes in tax rates and other provisions with a cumulative impact, positive and negative, of nearly $1 trillion over the next five years. I would consider any analyst who came within $10 billion a year of the correct revenue differential to be either very lucky, deserving of an award, or both.

In evaluating the revenue neutrality of the tax bill, we must also keep in mind that some of the prospective revenue increases are almost surely going to be offset by increased budget outlays. For example, the accounting adjustments which will be imposed on defense contractors, and will reduce their after-tax rate of return, probably will require higher defense outlays to keep the defense contractors whole. Hence, while the tax provisions could well be neutral with respect to the revenue side, they will increase the budget deficit.

There almost surely will be a significant number of unintended impacts from this bill. Perhaps 10 or 20 important mistakes will appear in retrospect. We will not know what they are, however, until after the bill is enacted and the problems surface. Hence, a much easier forecast than what the tax bill will do to the economy is what it will do to Congressional debate. As a consequence of the Tax Reform Act of 1986, there will be more tax reform bills, one in 1987 and, perhaps, in 1988 as well. I trust that by the time the long term arrives, i.e., the time when the strongly positive impacts of the current bill have become effective, the structure of marginal tax rates still will be close to the one on which you are about to vote.

Representative OBEY. Thank you. Mr. Brinner, please proceed.

STATEMENT OF ROGER BRINNER, DATA RESOURCES, INC.

Mr. BRINNER. I would also like to thank you for this opportunity. I will try to comment briefly on each of the areas that you requested some discussion on.

I would agree that the President's proposals which called for fairness, growth, and simplicity won't see their objectives fully achieved. The reform bill reported out does satisfy the fairness criterion, but it falls short on the other two.

If this bill is passed, growth will in fact slow in both the slow and the long term unless substantial changes in monetary and fiscal policy are made to offset the pressure toward a more labor-intensive economy.

This is not simply a bill which some have characterized as being antimanufacturing and proservice. It is prolabor intensive, anticapital intensive. There are both labor- and capital-intensive manufacturing sectors, just as there are labor- and capital-intensive service sectors.

The simplicity of the Tax Code may be improved for the estimated 6 million low-income people removed from the tax rolls, but business and private investment decisions will face as much or more complexity as under current law.

The cost of the improvement in fairness over growth can be mitigated if Congress, the President, and the Federal Reserve act promptly to improve the climate for capital formation. Specifically, Federal spending must be brought down close to the Gramm-Rudman-Hollings targets and the Federal Reserve must provide generous financial stimulus.

First, let me discuss the impacts in the markets of tax reform. Our simulation analysis with an econometric model indicates that reform may slow GNP growth by as little as 0.4 percentage point in 1987 and then raise the growth rate slightly in 1988 and 1989. This assumes some prompt help from the Federal Reserve. The miniscule differences in aggregate GNP, however, belie a detrimental change in the composition of output away from high productivity sectors and toward low-wage, low-productivity sectors.

The personal tax cut is expected to achieve $120 billion lower revenues over the next 5 years. Although next year's tax rates are lower only part way to the final goal, the base is almost fully expanded implying a small $16 billion tax cut in 1987. This is followed by a large reduction in 1988.

The immediate boost to disposal income spurs a 0.4 percent increase in consumption by 1988 and does tend to stabilize aggregate output in the economy.

However, lower tax rates and curbs on the deductibility of interest payments may discourage high-income taxpayers from making durable goods purchases on credit. Consequently, the increases in spending will be primarily from moderately priced goods and services. This tendency will be amplified by the stronger labor force participation and longer workweeks of secondary earners in a family who are given greater encouragement to work by the new 15 percent marginal tax rate. Families including such new employees will need to purchase more food away from home, more personal services and perhaps some additional low-priced automobiles.

On the topic of investment spending, spurred by the incentive provided by the 1981 tax bill, investment did rise dramatically after the 1982 recession. Today, with office buildings and rental apartments overbuilt and industry mired at an 80 percent capacity utilization rate, all categories of investment spending are weak or declining. The imposition of tax reform, which not only raises business taxes but also exchanged high-powered incentives like the investment tax credit and accelerated depreciation for the low-powered statutory rate cuts, will slow the retooling of factories and keep construction depressed longer than the correction in glutted markets would require. Tax reform will raise the required return on a capital good by 9 percent for equipment and by 28 percent for partnership-funded structures. Industrial structures put up by corporations, however, will actually see a slight decline in the required return.

The Tax Code will eliminate much of the special treatment enjoyed by real estate under current law. This will tend to raise rents for multifamily units and reduce construction in that sector.

With respect to your deficit concerns, the tax bill, as you are aware, should raise an estimated $11 billion in revenue in fiscal 1987, just enough to satisfy the Gramm-Rudman-Hollings deficit limits and reduce the need for additional spending cuts this year. However, if you accept that windfall, then you have to cope with $17 billion loss in fiscal 1988, making the Gramm-Rudman target all but unreachable.

Taking all the dynamic responses of taxpayer behavior and macroeconomic conditions into account, we expect reform to reduce total receipts by an average $8 billion per year below the level that would otherwise prevail with losses concentrated in 1988 and 1989.

Fortunately, considerable expenditure savings should also occur. The official calculations appear to ignore potential Government savings on net interest expenses, which we estimate to average $7 billion per year. These savings are primarily derived from our assumption that the Federal Reserve will indeed pursue more stimulative monetary policy to offset the contractionary pressure exerted by the tax reform legislation.

The Government should also achieve some other expenditure savings because, as I noted, this bill will provide a stimulus to labor-intensive industries and the Government is one of those.

With respect to international trade, reform is likely to lower the value of the dollar for two reasons. Reductions of the tax wedge in interest rates required by domestic borrowers and lenders will reduce nominal interest rates, pretax interest rates that you observe in the market. Since foreign taxpayers will not benefit from the lower tax rates, their returns will fall with the market rates, reducing the attractiveness of U.S. assets and, therefore, the dollar. The dollar's depreciation is also necessary from a competitive perspective. The lower business capital stock under tax reform will reduce worker productivity and America's ability to compete with foreign producers.

We estimate that the combination of slightly lower wages but much higher capital costs will require at least a 2 percent lower dollar than would otherwise be desirable. This will tend to keep our trade deficit from changing too much, but we must remember that that does give us a 2 percent or worse standard of living compared to the rest of the world.

On the issue of the impact on interest rates and financial markets, let me agree in advance from people who would challenge some of the interest calculations that borrowing and lending decisions are driven by after-tax interest rates. With no change in real after-tax rates or in behavior, lower tax rates will permit lower market interest rates. While this affect is theoretically sound as far as it goes, it ignores very important additional factors.

First, the expected reduction in the supply of domestic savings from this massive shift of taxation from the personal sector to the corporate sector. This is particularly important when the U.S. economy is already suffering from the stresses of a large Federal deficit. Private savings are likely to decline because of this $25 billion per year shift. The corporate tax increases will reduce business savings except to the limited extent this burden can be passed on to households through higher prices, lower dividends, and lower wages. On the other hand, most of the additional income afforded by the personal tax cuts, concentrated as it is among lower to middle income taxpayers, will be spent rather than saved.

In combination, these two effects suggest about a 4 percent net reduction in private domestic savings. The total national reduction will be on the order of $20 billion per year. This suggests to us that interest rates will decline by less than 1 percentage point on a pretax basis but actually rise by about a percentage point on a posttax basis. The true cost of borrowing to invest, either by a homeowner or by a business, will be increased by that percentage point.

We acknowledge that there will be efficiency gains that will offset some of the weakness in capital formation created by this bill, but if you go through the numbers carefully you cannot avoid the conclusion that the efficiency pains will be smaller than the loss of capital formation. We will have a less productive society which is more labor intensive.

How can this damage be offset? The Gramm-Rudman-Hollings legislation was originally motivated by the desire to stem the explosion of the Federal debt and the accumulation of massive foreign obligations. It recognized that the threat to the American standard of living posed by both current foreign competition and the future need to service the heavy oversea debt that tax reform legislation adds another compelling reason to pursue deficit reduction, the need to make room in the financial markets for greater volume of capital investment.

To evaluate the extent to which deficit reduction can offset the negative impact of the tax reform legislation, I prepared another simulation with our econometric model. In this scenario, I have additional spending cuts of approximately $50 billion spread among the major categories. These reductions are phased in over the next 3 years and are accompanied by sufficient monetary stimulus to offset all but a 0.2 percent deterioration in real GNP growth. Even stronger monetary stimulus is possible, but that would require the Fed to shed its lingering monetarism.

A personal tax increase could also be very beneficially substituted for a portion of the spending cuts. Thus, the numbers that I've presented for the new simulation should be seen as representing a larger class of policy scenarios embodying better balance of monetary and fiscal policy and not just the specific, narrow expenditure program that I laid out.

Under these conditions, the economy would be back on a strong course of long-term expansion by 1991. Investment could remain near 13 percent of GNP rather than falling to 12 to 12½ percent. In fact, the U.S. economy would be better positioned for the 1990's than in any other scenario because both the Federal deficit and the trade deficit would be virtually eliminated by the beginning of that decade.

My conclusion is that tax reform will depress economic growth in the short term and the long term. Lower investment will lead to a lower capital stock and, therefore, lower labor productivity. Greater efficiency in the use of capital can offset part but not most of this loss.

In normative analysis, this cost must be balanced against the unquantifiable gains in fairness and confidence in the tax system engendered by eliminating many deductions, lowering tax rates, and removing the often artificial distinctions between ordinary income and capital gains.

If all interested parties in Washington have the political will to make a full switch toward a balanced Federal budget and stimulative monetary policy, the country can achieve the fairness and efficiency gains without reducing the national living standard. Thank you.

[The prepared statement of Mr. Brinner follows:]

PREPARED STATEMENT OF ROGER BRINNER

TAX REFORM REQUIRES GRAMM-RUDMAN-HOLLINGS

by Roger Brinner and Jesse Abraham

The President's proposals of May 1985 called for fairness, growth, and simplicity in the tax code. The reform bill reported out of the conference committee and supported by the President does satisfy the fairness criterion, but falls short on the other two. If this bill is passed, growth will in fact slow in both the short and long terms unless substantial changes in monetary and fiscal policy are made to offset the pressure toward a more labor-intensive economy. The simplicity of the tax code may be improved for the estimated 6 million low-income people removed from the tax rolls, but business and private investment decisions will face as much or more complexity as under current law.

Congress and the Administration have labored mightily and against all odds to produce truly fundamental reform. There will be significant winners and losers from this bill, with the casting only partially related to the magnitude of lobbying funds. The cost of the improvement in fairness--i.e., lower growth--can be mitigated if the Congress, the President, and the Federal Reserve act promptly to improve the climate for capital formation. Specifically, federal spending must be brought down close to the Gramm-Rudman-Hollings targets and the Federal Reserve Board must provide generous financial stimulus.

THE MARKET IMPACTS OF TAX REFORM

Table 1 compares our trend simulation results with those assuming no tax reform. Reform slows GNP growth by 0.4 percentage point in 1987, but then raises the growth rate slightly in 1988 and 1989. The miniscule differences in aggregate GNP, however, belie a detrimental change in the composition of output away from high-productivity sectors and toward low-wage, low-productivity sectors.

Consumer Spending: Tax reform is expected to achieve a personal tax cut of $120 billion over the next five years. Although next year's tax rates are lowered only part way to the final goal, the base is almost fully expanded, implying a small ($16 billion) tax cut in 1987. This is followed by a large ($37 billion) reduction in 1988 when tax rates are lowered all the way. The net reduction shrinks in 1989 and 1990 as certain deductions for interest expenses and business losses are phased out. Our estimate of the timing of receipts changes appears in Table 2.

Table 2
Static Impact of the Conference Committee
Tax Reform Bill
(Billions of dollars, fiscal years)

	1987	1988	1989	1990	1991
Personal....................	-16	-37	-34	-16	-19
Corporate...................	27	20	19	25	31
ITC and Depreciation...	30	30	35	45	54
Rate Reduction.........	-11	-29	-36	-40	-44
Other....................	8	19	20	20	21
Total.......................	11	-17	-15	9	12

The immediate boost to disposable income spurs a 0.4% increase in real consumption by 1988 and stabilizes GNP. Still, the average percentage increase in after-tax income will be quite modest, with one loser for every four winners (Table 3). Lower tax rates and curbs on the deductibility of interest payments may discourage high-income taxpayers from making durable goods purchases on credit;

Table 1
Impacts of Tax Reform
(Percent difference from baseline unless otherwise indicated)

	1987	1988	1989	1990	1991	1987-91
Supply						
Potential Man-hours	0.0	0.1	0.3	0.5	0.7	0.3
Actual Man-hours	0.1	0.2	0.3	0.6	0.9	0.4
Business Capital Stock	-0.5	-1.2	-1.8	-2.4	-2.8	-1.8
Number of Homes	-0.1	-0.2	-0.2	-0.3	-0.3	-0.2
Full-Employment GNP	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Actual Nonfarm Output per Hour	-0.2	-0.1	-0.2	-0.4	-0.6	-0.3
Demand						
Consumer Spending	0.0	0.4	0.3	0.0	-0.1	0.1
Fixed Investment	-3.1	-4.4	-3.7	-3.6	-2.6	-3.5
Residential	-1.4	-0.5	-0.8	-0.1	1.5	-0.3
Nonresidential	-3.9	-5.8	-4.9	-4.9	-4.1	-4.7
Equipment	-2.9	-4.9	-5.1	-6.2	-5.5	-5.0
Structures	-6.6	-8.2	-4.4	-1.3	-0.1	-4.1
Real GNP	-0.4	-0.3	-0.2	-0.3	-0.2	-0.3
Wages and Prices						
Hourly Wages	-0.3	-0.6	-0.9	-1.2	-1.6	-0.9
Consumer Prices	-0.1	-0.3	-0.5	-0.7	-0.9	-0.5
Real Wages	-0.2	-0.3	-0.4	-0.5	-0.7	-0.4
Wholesale Industrial Prices	-0.1	-0.3	-0.5	-0.7	-0.6	-0.5
Financial Conditions						
Standard & Poor 500 Index	-5.5	-5.5	-5.6	-5.9	-4.2	-5.3
Dividend Yield*	-0.18	-0.29	-0.37	-0.42	-0.56	-0.36
Prime Rate*	-0.55	-0.75	-0.81	-1.02	-1.17	-0.88
Mortgage Rate*	-0.46	-0.30	-0.27	-0.50	-0.89	-0.48
Corporate Bond Rate*	-0.45	-0.25	-0.29	-0.50	-0.89	-0.47
Post-tax Profits	-13.1	-15.5	-6.4	-1.7	5.7	-5.8
Post-tax Cash Flow	-4.8	-5.7	-4.2	-6.9	-8.6	-6.1
Other Indicators						
Unemployment Rate*	0.1	0.2	0.1	0.1	0.1	0.1
Employment	-0.1	-0.1	0.0	0.0	0.0	-0.1
Industrial Production	-0.7	-1.1	-0.6	-0.7	-0.4	-0.7
Capacity Utilization Rate	-0.7	-0.4	0.8	1.2	2.1	0.6
Federal Budget						
Taxes**	-10	-25	-16	-4	14	-8
Personal**	-22	-47	-34	-31	-27	-32
Corporate**	14	25	22	33	48	29
Expenditures**	-3	-7	-10	-15	-22	-11
Interest**	-3	-5	-6	-9	-12	-7
Deficit**	7	18	5	-12	-36	-3

*Absolute difference in rate.
**Absolute difference: billions of dollars.

Table 3
Impact of the Tax Reform Bill on Tax Liability
(1988 income levels)

Income Class (Thousands of 1988 dollars)	Percentage Change in Income Tax Liability	Percentage Change in After-Tax Income
Less than $10	-85.7	2.9
10-20	-22.3	1.4
20-30	-9.8	2.9
30-40	-7.7	0.8
40-50	-9.1	1.1
50-75	-1.7	0.1
75-100	-1.2	0.2
100-200	-2.4	0.8
200 and Above	-2.2	0.7
Total	-6.1	0.8

Source: Joint Committee on Taxation and DRI calculations.

consequently, the increases in spending will be primarily for moderately priced goods and services. This tendency will be amplified by the stronger labor-force participation and longer work-weeks of secondary earners in a family, who are given greater encouragement to work by the new 15% marginal tax rate. Families including such new employees will need to purchase more food away from home, more personal services, and perhaps additional low-priced automobiles.

Investment: Spurred by the incentives provided by President Reagan's 1981 tax bill, investment rose dramatically after the 1982 recession. Today, with office buildings and rental apartments overbuilt and industry mired at an 80% capacity utilization rate, all categories of investment spending are weak or declining. The imposition of tax reform--which not only raises business taxes but also exchanges high-powered incentives like the investment tax credit and accelerated depreciation for low-powered statutory rate cuts--will slow the retooling of factories and keep construction depressed longer than the correction in glutted markets would require. Tax reform will raise the required return on a capital good as a percent of the purchase price by 9% for equipment and by 28% for partnership-funded structures; the return for industrial structures, however, actually declines.

The tax code changes will eliminate much of the special treatment enjoyed by real estate under current law. Although owner-occupied housing survived largely unscathed, the longer depreciation period, limitations on the deductibility of rental property losses, and lower marginal rates drastically reduce the incentives to invest in rental housing. Higher future tax payments on property and structures will be felt immediately as a capital loss to current owners, curtailing new construction and raising rents.

Chart 1
Multi-Family Housing Starts
(Thousands of units)

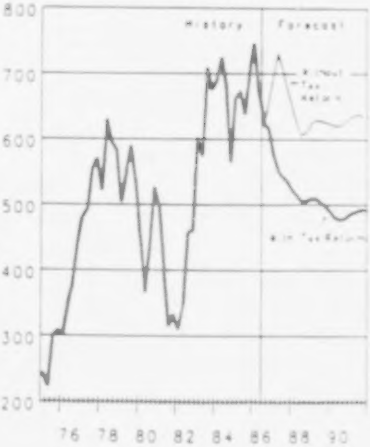

Table 4
Impact of Tax Reform on Investment Returns
(Percent)

	1979:3	1985:4	1988:1
Corporate Equipment			
Required Return As Percent of Purchase Price	20.6	18.3	19.9
Cost of Funds	13.3	9.7	8.1
Average Lifetime (Years)	8.1	6.2	5.1
Present Value of Depreciation	0.68	0.83	0.83
Net ITC*	9.1	7.7	0.0
Corporate Structures			
Required Return As Percent of Purchase Price	17.1	14.6	13.9
Cost of Funds	13.3	9.7	8.1
Average Lifetime (Years)	39.1	19.0	31.5
Present Value of Depreciation	0.24	0.52	0.27
Investor Structures**			
Required Return As Percent of Purchase Price	4.8	7.3	9.4
After-Tax Cost of Debt	8.3	7.1	6.8
Average Lifetime (Years)	39.1	19.0	31.5
Present Value of Depreciation	0.13	0.32	0.16
Net Rehab. Tax Credit*	0.0	1.1	0.7
Addendum			
Cost of Equity	18.1	11.3	9.0
Corporate New Issue Rate	9.5	10.4	8.6
Inflation Rate (GNP deflator)	8.1	3.7	4.1
Expected Inflation Rate	7.6	4.4	3.0

*Average tax credit reduced by the value of the basis adjustment.

**Investor structures are held for 10 years and financed with 80% leverage from a 20% equity participation. The passive loss limitation is assumed to reduce the value of interest and depreciation deductions by 25%.

Government: The tax bill should raise an estimated $11 billion in revenue in fiscal 1987, just enough to satisfy the Gramm-Rudman-Hollings deficit limits and reduce the need for additional spending cuts this year. The plan "loses" $17 billion in fiscal 1988, however, making the G-R-H target all but unreachable. Our forecast assumes that Congress will decide not to count the revenue gains from tax reform against the 1987 G-R-H target so that they can avoid the losses later on.

Revenue could, however, fall short of promised gains, eventually requiring an increase in taxes. For example, official revenue estimates include a questionable $28 billion gain from greater enforcement and compliance; on the other hand, the estimates do not appear to have exaggerated revenue gains from new taxes on any remaining tax shelters. In addition, since depreciation allowances should drop off significantly after 1991, corporate tax liabilities will continue to expand strongly in the early 1990s. Taking all dynamic reactions into account, tax reform is expected to reduce total receipts by an average of $8 billion per year below the level that would otherwise prevail, with losses concentrated in 1988 and 1989.

Fortunately, comparable expenditure savings should occur. The official calculations appear to ignore potential government savings on net interest expenses, estimated by DRI to average $7 billion per year. These savings primarily derive from our assumption that the Federal Reserve will pursue more stimulative monetary policy to offset the contractionary pressure exerted by the tax reform legislation. Other expenses should also be slightly lower (by $4 billion per year) because of the reduction in the real wage level (the government is, after all, relatively labor-intensive).

Trade: Reform is likely to lower the value of the dollar for two reasons. Reduction of the "tax wedge" in interest rates required by domestic borrowers and lenders will reduce nominal market interest rates. Since foreign taxpayers will not benefit from the lower tax rates, their returns will fall with market rates, reducing the attractiveness of U.S. assets and therefore the dollar.

The dollar's depreciation is also necessary from a competitive perspective. The lower business capital stock under tax reform will reduce worker productivity and America's ability to compete with foreign producers. As discussed elsewhere, reduced competitiveness may require at least a 2% exchange rate adjustment.[1]

Financial: Borrowing and lending decisions are driven by after-tax interest rates; with no change in real after-tax rates or in behavior, lower tax rates thus permit lower market rates. While this "Fisher effect" is theoretically sound and might lead one to expect rate declines of 175-250 basis points from tax reform, the calculation ignores several very important factors: the expected reduction in the supply of domestic savings; lower demand for savings because of the elimination of tax-based investment incentives; and the Federal Reserve's willingness to purchase more securities to forestall economic weakness. Giving full recognition to these factors, the DRI Model simulation indicates that tax reform will lower rates by only 25-75 basis points (Table 5).

Of particular importance is the likely reduction in the supply of domestic savings, especially when the U.S. economy is already suffering from the stresses of a large federal deficit. Private savings are likely to decline because of the massive shift of post-tax income from

Table 5
AAA Corporate Bond Rates With and Without Tax Reform
(Average values, 1987-91)

	With Reform	Without Reform	Reform Impact
I. Market/Pre-tax Bond Yield	8.83	9.41	-0.59
II. Effective Rate Post-tax			
Corporate Borrower			
Federal Tax Rate	.34	.46	
+ State Tax Rate (10%)			
x (1 - Federal Tax Rate)	.066	.054	
= Composite Tax Rate	.406	.514	
Market Yield x (1-Composite)			
= Effective Bond Rate	5.25	4.57	+0.68
Personal Investor			
Federal Tax Rate	.33	.50	
+ State Tax Rate (10%)			
x (1 - Federal Tax Rate)	.067	.050	
= Composite Tax Rate	.397	.550	
Market Yield x (1-Composite)			
= Effective Bond Rate	5.32	4.23	+1.09

NOTE: The market rate required under the new tax rates to produce the "without reform" post-tax yields would be 7.69% [4.57/(1-.406)] for the corporate borrower and 7.01% [4.23/(1-.397)] for the personal investor. These are the rates implied by a simple Fisher calculation.

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[1] For a comparison of U.S. and foreign tax systems and the investment cost implications, see R. Brinner, J. Abraham, and N. Gault, "Round 3 of Tax Reform," DRI Review of the U.S. Economy, March 1986.

businesses to individuals. The corporate tax increase will reduce business savings (retained earnings plus depreciation allowances) except to the limited extent that this burden can be passed on to households through higher prices, lower dividends, and lower wages. Most of the additional income afforded by the personal tax cut, concentrated among lower- and middle-income taxpayers, will be spent rather than saved. In combination, these two effects suggest about a 4% net reduction in private domestic savings; over the 1986-91 interval, personal savings are thus expected to be only $5 billion higher while corporate savings are $24 billion lower.

With the supply of savings reduced more than the demand, its price (the post-tax interest rate) will rise. The simulation comparisons suggest that a corporate borrower will see an effective increase of approximately 70 basis points and a high-income individual investor will experience an increase in return close to 100 basis points (Table 5). The exact results for each taxpayer will depend on the specific tax rate. Of course, an individual borrowing to finance a home will face the same 100 basis point increase in post-tax financing costs.

The availability of higher post-tax bond yields, the loss of special treatment for capital gains, and the sharp increase in corporate taxes will all serve to depress the stock market. We have conservatively estimated the drop to be at least 5.5%. In today's market where 2% daily increases and decreases are not uncommon, it is difficult to say how much of this expected decline the market has already absorbed. Although we expect the market to be "surprised" next year when high tax liabilities finally depress after-tax earnings, we have not built this shock into the simulation results. A more adverse stock market reaction thus adds an important downside risk to our projections.

EFFICIENCY GAINS VERSUS CAPITAL FORMATION LOSSES

The tax code plays a significant role in many of the economic decisions we make. The current deductibility of interest reduces the cost of homeownership and of financing a car or vacation; the deductibility of charitable contributions encourages giving; generous treatment of losses in oil and gas exploration and construction of rental units attracts investment funds. If one believes that people respond to incentives, then the Tax Reform Act of 1986 will bring about a fundamental restructuring of the economy as individuals reoptimize their behavior based on the new rules. Indeed, part of the argument for reform is that the existing tax code encourages the wrong sorts of activities. The following discussion focuses on areas of the economy that will see changes, but measured in decades rather than years.

Labor Supply: Lower marginal tax rates on wages reduce the distortion in the decision to supply labor or to enjoy leisure. The supply of primary workers is relatively insensitive to wage rates, but the number and work hours of second earners in a household--particularly married women in lower- and middle-income families who currently face taxation on their wages at the top marginal rate of their spouses--could increase, significantly. Most second earners will now face a 15%, rather than a 20-35%, marginal rate. Our survey of the relevant literature suggests a substantial long-term expansion of the labor supply of as much as 2% of current hours.

Productivity and Capital Allocation: Greater labor supply will put downward pressure on real wages at the same time that the required return on business equipment increases. Corporations will thus find it more cost-effective to adopt a technology that uses more labor and less capital than the current system. This will raise employment by enough to absorb the new workers, but unambiguously reduce worker productivity and the U.S. standard of living.

Tax reform enthusiasts dispute this claim of lower productivity. They assert, without any scientific basis, that even if the capital-labor ratio is cut, the efficiency gains from a "true" economic allocation of national savings will more than compensate for this loss. As noted in the first DRI tax reform study in January 1985, however, our simulations allow generously for potential efficiency gains. In the current case, output per labor hour (for any given level of the capital stock and cyclical state of the economy) rises by 0.1% per year beginning immediately, and thus by 0.4% by 1991. Nevertheless, the true cumulative long-run efficiency gain--after the economy has operated under the new rules for decades--will probably be only 0.3-0.7%.[2]

To understand this conclusion, consider an economy using three types of capital (K_1, K_2, K_3) and allocating total savings to each in inverse proportion to their effective tax rates (e.g., $K_1/K_2 = (1-t_1)/(1-t_2)$), as would be the case under a Cobb-Douglas technology. Assume for this illustration that total savings and investment is held at 300 units. Assuming a Cobb-Douglas production function in which labor accrues two-thirds of national income and capital one-third, it can be shown that even a dramatic switch to fully neutral taxation ($t_1=t_2=t_3=0.2$) from a very biased system ($t_1=0$, $t_2=0.2$, $t_3=0.4$) would lead to only a 0.7% gain in total output per hour.

The gain would be small even though the reallocation of the national capital stock would indeed be massive: the previously untaxed sector capital stock (K_1) would decline by 20% (from 125 units to 100 units) as the previously heavily taxed sector stock (K_3) rose by 33% (from 75 to 100). The initial tax rates (0%, 20%, and 40%) used in our example are reasonable approximations of the current tax treatment of producers' durable equipment, owner-occupied housing, and nonresidential structures, respectively. The proposed tax reform would not, however, push the U.S. even close to full neutrality with all effective tax rates equal to 20%. Thus, the efficiency gains actually achievable during the rest of this century are probably less than the 0.4% our simulation credits to tax reform in 1991.

OFFSETTING THE DAMAGE

The Gramm-Rudman-Hollings legislation was originally motivated by the desire to stem the explosion of the federal debt and the accumulation of massive foreign obligations. It recognized that the threat to the American standard of living posed by both current foreign competition and the future need to service a heavy overseas debt. The tax reform legislation adds another compelling reason to pursue deficit reduction: the need to make room in the financial markets for a greater volume of capital investment.

The baseline long-term DRI simulation (including the tax reform bill) assumes that the President and Congress fail to meet the G-R-H targets. In this scenario, the federal deficit reaches $98 billion in fiscal 1991. With this much pressure on the economy and the financial markets, long-term corporate bond rates in 1991 are still near 9%, or 4.5-5.0% above likely inflation expectations. The business capital stock is projected to have risen at only a 3.1% rate from 1986 to 1991, compared with the 3.7% rate feasible without tax reform.

To quantify the investment support that could be bought with greater federal spending restraint and easier monetary policy, we created an alternative simulation that includes additional spending cuts of $50 billion: $20 billion in defense, $10 billion in nondefense purchases, and $20 billion in state aid or government subsidy programs (Table 6). These reductions are phased in over the next three fiscal years and are accompanied by sufficient monetary stimulus to offset all but a 0.2% deterioration in real GNP growth during 1987 and 1988. Although stronger monetary stimulus is possible, the simulations suggest that this would require the Fed to raise its M1 and M2 targets significantly. A personal tax increase could also be substituted for a portion of the spending cuts. Thus, the new alternative simulation represents a large class of policy scenarios embodying better balance of monetary and fiscal policies.

Under these conditions, the economy could be back on a strong course of long-term expansion by 1991. Indeed, the U.S. economy would be better positioned for the next decade than in any other scenario because both the federal deficit and the trade deficit would be virtually eliminated.

CONCLUSION

Our positive, or objective, conclusion is that tax reform will depress economic growth next year and into the long term: lower investment will lead to a lower capital stock and therefore

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[2] For further explanation, see R. Brinner et al., "The Treasury Tax Proposal: Steps Toward Neutrality," DRI Review of the U.S. Economy, January 1985.

Table 6
The Potential to Offset Tax Reform Damage
Through Fiscal Restraint

	Tax Reform Alone (Baseline DRI Simulation)		Tax Reform Plus Fiscal Restraint (Additional spending cuts and monetary stimulus)		Baseline without Tax Reform	
Real Growth Rate, 1986-91						
Fixed Investment, Total	2.6		3.4		3.2	
Producer Durables	3.8		4.7		5.2	
Nonresidential Construction	1.4		2.0		1.4	
GNP	2.7		2.9		2.8	
Manufacturing Production	3.4		3.9		3.5	
Other Economic Parameters	1988	1991	1988	1991	1988	1991
Federal Budget						
Receipts	941	1201	933	1205	966	1187
Expenditures	1077	1298	1042	1224	1084	1319
Interest	137	160	127	136	143	172
Surplus (Deficit, -)	-137	-97	-109	-19	-118	-132
Corporate Bond Rate	9.2	8.8	6.8	7.4	8.5	9.5
Net Exports	-70	-40	-54	-11	-76	-53
Real GNP per Capita (1982 prices)	15,704	16,637	15,727	16,777	15,846	16,666
Business Investment as a Percent of Real GNP	12.2	12.6	12.3	13.0	13.0	13.1

lower worker productivity. Greater efficiency in the use of capital can offset part, but not most, of this loss.

In normative analysis, this measurable cost must be balanced against unquantifiable gains in "fairness" and "confidence" in the tax system engendered by eliminating many tax deductions, lowering tax rates, and removing the often artificial distinctions between ordinary income and capital gains. If all interested parties in Washington have the political will to make a full switch toward a balanced federal budget and stimulative monetary policy, the country can achieve the fairness and efficiency gains without reducing the national living standard.

Representative OBEY. Thank you very much. Mr. Jasinowski, please proceed.

STATEMENT OF JERRY J. JASINOWSKI, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. JASINOWSKI. Thank you, Mr. Chairman. I, too, am delighted to be here with the rest of the panel to discuss the economic impact of the current tax reform proposal.

Mr. Chairman, as you know, there are five criteria by which we can judge this bill: simplicity; efficiency; equity; growth; and international competitiveness. I submit that it does not do well on simplicity; that it has, as Mr. Brinner suggests, efficiency gains but a substantial number of those are offset by the efficiency losses because of the heavier taxes on capital; that it scores quite highly with respect to equity both on the individual side and in particular with respect to corporations, because in fact from the corporate side from the business point of view, much of the support for this tax reform bill came from the view of business leaders that there was too much of a dichotomy between high rate and low rate corporations, this situation could not be justified.

On growth, I submit it is much as Mr. Brinner and Mr. Greenspan suggest. It is either a wash or mildly negative in the short run simply because the losses with respect to the decline in capital spending and further lack of improvement on the trade deficit are likely to offset the gains with respect to increased consumer spending.

Finally, with respect to international competitiveness, Mr. Chairman, to which I would like to devote most of the remaining time I have, I think that it scores very poorly. I think that the overall thrust of this tax reform package will worsen international competitiveness for the United States and be harmful with respect to making progress with respect to the trade deficit.

Mr. Chairman, I have a somewhat longer prepared statement I would like to ask be submitted for the record and then to summarize these views on international competition.

Representative OBEY. Sure.

Mr. JASINOWSKI. Before that, let me just quickly touch on two of the questions you raised. One, the question of revenue neutrality—and again, I think that it's clear that both because of the uncertainties associated with some of these provisions, that fact that historically we have tended to overestimate the revenue gains from these major tax reform proposals, and I think most importantly because of the likelihood that growth will not be as fast as they are assumed to be in the revenue estimates—I think that you will have less than a revenue neutral bill here. And I would concur with the approximate magnitudes that Mr. Brinner suggested.

With respect to the question of what will happen if we pass this bill in terms of future pressures, I submit we will be back with a tax bill on technical amendments next year, where those technical amendments may be of a magnitude as large or larger than historically most tax bills have been, and I submit we will be back on the revenue side because of continued problems with the deficit.

I don't necessarily endorse this, Mr. Chairman. As you suggested in your opening remarks, we have had far too many changes in the tax law. This will be the forth change since 1980. It makes it extremely difficult for business planning. But I suspect that the problems associated with this bill and our failure to address the Federal deficit will bring us back to an era in which we're at taxes every year or two until we get our thinking straighter on this particular issue.

Quickly summarizing on the international trade side, Mr. Chairman, as I said, it will be harmful for the long-term competitiveness and progress with our trade deficit, and this is for several reasons.

First, the most obvious point is that it will raise the user cost of capital by large magnitudes, the estimates varying between 10 and 20 percent, depending upon how you look at it and what model you use. We have referenced a series of investigations that have been made on this and I would submit that something in the neighborhood of 10 to 15 percent is the most likely case in terms of increasing the cost of capital.

This isn't very hard to figure out. If you increase taxes by $120 billion on the corporate side and if you at the same time eliminate the ITC which is going to amount to $131 billion over 5 years, you obviously greatly raise the cost of production and a good part of that is the cost of capital.

Second, the international competitiveness in trade position will be harmed because this increase in the user cost of capital will lower productivity growth, move us more toward a labor-intensive economy, as Mr. Brinner suggested, and will in the process of doing that raise unit labor costs.

The fact of the matter is, the priorities in this bill are to encourage labor-intensive industries rather than capital-intensive industries. It is extremely hard on capital-intensive industries and moves us diametrically away from where we started out in 1980. That's the flaw in the bill with respect to international competitiveness.

Third, the bill redistributes tax liabilities from individuals and toward business which will tend to raise consumption. Increased consumption will raise demand for imports relative to current law. And this is the point I would most stress, Mr. Chairman. There's been much discussion about how the user cost of capital will raise the cost of production in this country, but very little appreciation for the fact that we are really asking or encouraging people to go out and consume more in this bill, and that that is going to suck in imports into the American economy at a continued high rate.

This has been in large part the problem with the trade deficit over the last several years. The proportion of the trade deficit in the U.S. as a part of GNP is much higher than in other countries, and this is going to continue as a result of this legislation.

As we indicate in the testimony, the effects of this tax bill on both interest rates and exchange rates are pretty ambiguous. It is conceivable that you will get efficiency gains that would lower interest rates and, in turn, exchange rates somewhat. But the larger deficit associated with this bill could work in the opposite direction and, although I think that the effect of this bill will be to lower interest rates and exchange rates in the next year, that will be primarily because it will soften the economy and that economic growth will be somewhat less robust than it would be otherwise. And as economic growth slows, one of the favorable effects you get, among the few, is an improvement in the trade deficit primarily because of the exchange rate improvement and, in turn, because you have lower consumption of imports.

I would like to turn to my fifth point on this trade question and that is the efficiency argument. One argument that has been made on behalf of tax reform is that the overall efficiency of resource allocation will be increased due to the greater equalization of tax rates and the reduction in abusive tax shelters.

This is true. The magnitude of these efficiency gains, however, are much less than the efficiency that will be lost by the elimination of both the ITC and the changed depreciation schedules.

You can see that just by taking a look at some of the crude revenue numbers. The gain in revenue by eliminating the ITC and depreciation over 5 years is roughly $140 to $150 billion, and that is going to be a major negative impact on efficiency because you are taxing capital more and there's no way that you can argue that there are inefficiencies within those numbers of more than, in my opinion, $10 or $20 billion, whereas, on the other hand, the shelters that are being eliminated where you may get major efficiency gains are only in the neighborhood of $30 billion.

So there will be efficiency gains in this bill, but there are going to be efficiency losses which are going to be larger.

Mr. Chairman, the statement outlines a number of other effects on the international trade front, that this will reduce profitability and cash-flow which will make it more difficult for firms to have the resources necessary to improve competition, that it may encourage some off sourcing of production abroad because of changed relative depreciation schedules, and so forth.

I would like to bring my statement to a close at this point, though, and to end on my view that the international competitiveness question was never seriously addressed in the tax reform debate from what I could see in either House as a dominant priority. We were interested in equity. We were interested in cutting individual rates in order to gain political benefits. The kind of international challenge that we face was not seriously addressed and this bill moves in the opposite direction of what you would do if you wanted to be internationally competitive because if raises the user cost of capital and encourages consumption at a very high rate. Thank you, Mr. Chairman

[The prepared statement of Mr. Jasinowski follows:]

PREPARED STATEMENT OF JERRY J. JASINOWSKI

I am Jerry Jasinowski, Executive Vice President and Chief Economist of the National Association of Manufacturers (NAM).

NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Our members range in size from the very large to over 9,000 small manufacturing firms that each have less than 500 employees. NAM member companies employ 85% of all workers in manufacturing and produce over 80% of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

On behalf of our members, I am pleased to be here today to express the Association's views on the effects of tax reform on the international competitiveness of American industry.

I. INTRODUCTION AND SUMMARY

The issue of the implications of tax reform for international competitiveness should in our view be evaluated in conjunction with rather than as distinct from its implications for the economy as a whole. With respect to its aggregate economic impact, the tax reform proposals have both positive and negative implications. The major positive elements include substantial tax rate reductions on individuals and businesses paying high tax rates, with the result that the ultimate distribution of tax liabilities will be more equitable than under current law. The major negative elements have to do with the fact that revenue losses are made up primarily by removing implicit subsidies for investment, with the result that the burden of taxes will be shifted primarily onto capital intensive manufacturing firms that are heavily exposed to international competition.

The reason that the tax bill should be considered in conjunction with rather than in isolation from its general economic considerations is that the condition of the overall economy is of paramount importance in determining performance in international markets. In this respect, the trade deficit feeds back into GNP growth rates through the channel of net exports, while the trade deficit in itself is partially dependent on the level of domestic consumption of imports, which in turn depends upon GNP growth. Thus certain general economic considerations, for instance whether tax reform precipitates a recession, or its indirect implications for interest rates and the exchange rate, will influence the size of the trade deficit. Moreover, changes in the macroeconomic environment have significant implications for microeconomic decision-making, which in turn will tend to affect the behavior of imports and exports.

This statement consists of two major sections. Section II examines the macroeconomic implications of tax reform, focusing on differentials in aggregate demand, changes in capital and labor costs, and exchange rate effects. Section III examines microeconomic considerations such as changes in efficiency, effects on individual behavior, effects on corporate profits, and effects on the general climate for business decision-making.

The major conclusions of this statement are as follows:

1) On a macroeconomic level, tax reform will raise the user cost of capital by large magnitudes, raising the cost of production for manufacturing corporations that are in direct competition with foreign suppliers.

2) The increase in the user cost of capital will lower productivity growth, thereby raising unit labor costs.

3) The fact that the bill redistributes tax liabilities away from individuals and toward business will tend to raise consumption. Increased consumption will raise demand for imports relative to current law.

4) Its effects on the exchange rate are ambiguous. If tax reform lowers interest rates, the dollar will tend to depreciate more rapidly than under current law. Unfortunately, the issue of whether interest rates will be lowered remains unresolved, and it is possible that interest rates will fall primarily because tax reform will produce a weaker economy. In this eventuality, the lower dollar and improved trade conditions will only be achieved at the expense of slower growth.

5) On a microeconomic level, tax reform will reduce profitability and cash flow, particularly in capital-intensive industries that are already subject to import pressure.

6) It may also encourage off-sourcing of production to foreign countries because of increased domestic production costs, and in order to take advantage of tax incentives overseas.

7) One argument that has been made on behalf of tax reform is that the overall efficiency of resource allocation will be increased due to the greater equalization

of tax rates and the reduction in abusive tax shelters. This is true. The magnitude of these efficiency gains are difficult to measure, however, and it seems unlikely that these efficiency gains will be sufficient to compensate for efficiency losses associated with the higher cost of capital. If measures such as productivity are taken as indicators of aggregate efficiency, the conclusion is that on balance the efficiency of the economy is likely to decrease.

8) Other possible microeconomic factors such as greater entrepreneurialism or greater savings and labor force participation are also difficult to demonstrate. The evidence suggests that these effects may be relatively small. Even if there are some favorable changes in individual behavior, these cannot be demonstrated to have similarly favorable implications for trade.

9) Finally, while tax reform purports to achieve greater neutrality and it does so in some respects, it is not neutral on the tax treatment of income and consumption. In this respect, it moves the tax system even further away from taxation of consumption and further penalizes savings and investment. It should be noted here that the experience with consumption taxes in countries that have used them is that they tend to reduce demand for imports both by lowering consumption and by raising import prices.

II. MACROECONOMIC FACTORS

2.1 A General Framework

Macroeconomic theory suggests three major channels determining the trade deficit,

- differentials in aggregate demand across national boundaries;
- differentials in exchange rates;
- differentials in national price levels.

The price term must in turn take account of labor and capital costs. Prices therefore are a a function of 1) wage costs less productivity, 2) the rental price of capital, and 3) other factors such as the price of imports and the amount of slack in the economy.

In this frame of reference, an analysis of the macroeconomic impact on tax reform on trade requires looking at several issues, 1) its effects on aggregate demand, 2) its effects on the exchange rate, 3) the user cost of capital, and 4) other domestic costs.

2.2 Aggregate Demand

Tax reform will redistribute income to consumers while raising taxes on business by about $120 billion over five years. The effect will therefore be to stimulate consumption spending, thereby raising demand for imports. It should be noted that the marginal propensity to import is substantially higher for consumer goods than for capital equipment, meaning that a shift in the spending mix from investment to consumption is associated with an increase in imports. The extent to which tax reform will stimulate consumption at the expense of investment is substantial. Simulations of the conference committee tax reform bill using the Washington University macromodel indicate that by 1991, the consumption share of GNP will rise by slightly less than 1% while the investment share will decline by more than -10%.

This is a highly significant shift because a large part of the increase in the trade deficit over the last few years has been directly attributable to differentials in aggregate consumption between the United States and the other industrial countries. During the period 1982-1985, the growth rate of domestic demand as measured by GNP less net exports averaged 4.5% per year in the United States, compared to 3.2% in Canada, 2.4% in Japan and only 1.1% in Europe. The extreme slack in the EEC countries is attributable in large measure to the inherent conservatism of macroeconomic policy in West Germany, where the growth of domestic demand averaged only 0.2% per year. In 1985-86, this differential narrowed somewhat, with Canada actually surpassing the United States (5.2% versus 4.3%), but with the United States continuing to surpass Japan (3.5%), Germany (1.6%) and Europe as a whole (2.9%). Tax reform will tend to widen the consumption differential.

The one scenario in which tax reform will not worsen the consumption differential between the United States and the other industrial countries would be in the event that it causes a recession — a possibility given the pecular phase-in provisions of the tax legislation. The current tax bill front loads the revenue increases through the "stagger" provision, whereby corporate taxes are raised six to eighteen months in advance of the countervailing tax reductions, while individuals are also subject to transitional tax rules prior to the full implementation of the rate reductions. The net effect is a tax increase of approximately $23 billion in the first half of 1987. This in itself is likely to slow the economy relative to current law, and while it is unlikely to produce a recession in and of itself, taken in conjunction with other contractionary forces—high levels of indebtedness and the Gramm-Rudman spending cuts—this combination of factors could plausibly engender a cyclical downturn.

In the event that a recession were to emerge in 1987, the trade deficit would improve relative to current law due to the shortfall in domestic demand, but only at the cost of much greater losses in domestic output. In essence, because the sensitivity of GNP to changes in domestic aggregate demand is considerably larger than that of net exports, the magnitude of the output losses from a cyclical downturn will be correspondingly larger than the improvement in the trade accounts. This point underlines the reason for evaluating trade competitiveness in relation to developments throughout the entire economy rather than in isolation. While it is possible to generate scenarios in which the trade deficit improves under tax reform, this would only be at the expense of unacceptably large output losses in other areas.

2.3 Exchange Rate Effects

A highly significant but largely unresolved issue is whether tax reform would lower the exchange rate more rapidly than under current law,. If so, the trade deficit would initially deteriorate due to the J-curve, but would ameliorate more rapidly thereafter.

In order to evaluate this contingency, it is useful to differentiate two scenarios which could produce a sharper decline in the dollar, 1) a major loss of foreign confidence in the United States, leading to massive repatriatians of capital, and 2) a decline in interest rates. The first contingency would clearly be unfavorable. Other than some unforseeable political calamity, the only development likely to trigger such a loss of confidence in the American economy would be a major recession. In this eventuality, the dollar would depreciate so rapidly that monetary policy would have to be tightened in order to prevent further devaluation, thereby worsening the cyclical output losses. In this scenario, the trade deficit would improve but only at the expense of a greater contraction in GNP, as discussed above. While a recession in 1987 cannot be ruled out at the current time, it is unlikely at this juncture that it would be sufficiently severe to set off a devaluation crisis. This kind of "worst case" scenario can therefore be assigned a relatively low probability at the current time.

Another question altogether lies with whether tax reform will tend to lower interest rates. If so, the differential in real interest rates between the United States and the other industrial countries would fall, accelerating the depreciation of the dollar that has been in evidence since early 1985. Here, it is important to distinguish between the direct effects of the tax bill and its indirect effects, through channels such as lower growth.

The argument that rates will fall due to the direct effects of the tax bill appears to rely on the following premises: that the decrease in the implicit subsidy for mortgages and the elimination of the subsidy for personal non-mortgage debt will lower demand for credit, or conceivably that the real after-tax rate of return would increase, thereby inducing financial decision-makers to lower rates. However, there are countervailing arguments.

First, there have been no major studies demonstrating a significant sensitivity of interest rates to changes in tax law, and in fact the majority of empirical studies have emphasized different causes altogether, with the result that the prediction of a decline in interest rates must be viewed as something of a theoretical proposition rather than a generally-accepted thesis.

Secondly, tax reform may have other implications that would militate against any reduction in interest rates, for instance, anticipation of a larger Federal deficit. The revenue estimates produced by the architects of the tax bill demonstrate that tax reform will tend to lose revenue in the out-years, thereby raising the fiscal deficit. To the degree that this is anticipated by financial markets, expectational factors would tend to raise long-term interest rates. In this respect, a recent NBER study by Branson, Fraga and Johnson (1985) suggests that the ERTA tax cuts had this effect. Financial markets were not deceived by the now discredited "Laffer curve"; rather they correctly anticipated that ERTA would lose revenue, generating expectations of a larger Federal deficit and raising expectations premia on interest rates.

The result is that the major factors likely to produce a decline in interest rates under tax reform are not the changes in the tax laws themselves, but rather a series of different reasons. First, because of the decrease in capital investment associated with tax reform (see below), the economy is likely to be weaker in 1987, by about 1 percentage point of GNP, lowering interest rates through the channel of decreased demand for credit. Secondly, in anticipation that tax reform will produce a weaker economy and in an effort to prevent a recession, the Federal Reserve is currently following an aggressive strategy designed to lower market rates through successive cuts in the discount rate. Thus it is highly probable that interest rates will decline in 1987 more than under current law, albeit through more indirect types of mechanisms than have sometimes been suggested. Consequently, the exchange rate is also likely to fall more rapidly than under current law.

Regrettably, it is difficult to estimate the magnitude of this effect. The tax bill is sufficiently recent that its implications for the economy have yet to be fully assessed. Moreover, the determination of exchange rates represents one of the weaker areas in contemporary econometric modeling, with the best equations showing large and systematic forecast errors. If the fall in the exchange rate were sufficient, the trade deficit would jump initally due to the J-curve, but would then converge back to its current law path. It would, however, require a very substantial fall in the exchange rate to negate the effects of the shift in the output mix toward greater consumption. The longer-term implications of tax reform for the exchange rate are clearly a fertile ground for further research, but as yet little is known as to the magnitude of the resulting trade effects.

2.4 The Cost of Capital

Any number of studies have been conducted on the implications of tax reform with respect to the cost of capital. The consensus is that the successive tax reform bills would raise the cost by magnitudes of 15% to 20% in the first year alone. This is based on models which have ascribed a considerable weight to after-tax profitability in determining the capital cost. For instance, a typical representation involves the purchase price of capital relative to output prices, adjusted for the investment tax credit, the marginal corporate tax rate, the value of depreciation allowances, gains from leverage, discounted for expected inflation [Prakken, Meyer and Varvares (1984)]. Recent studies by Chase Econometrics and Lawrence Meyer and Associates have estimated the increase in the cost of capital to be in the area of 18% under the Conference Committee tax bill, even without the stagger provision.

Some criticism has been directed against this prognosis. Some writers have claimed that tax reform will lower the cost of capital, presumably because of the individual and corporate rate reductions, and have advanced the further claim that this will raise capital inflows to the United States. As the attached review of the literature demonstrates, however, the rate of return on investment is far more sensitive to targeted tax incentives for investment and effective capital gains tax rates than to marginal individual tax rates. A further argument against this claim is that the capital inflows into the United States in 1981-84 were not caused by decreases in individual tax rates, but rather by the extraordinarily high level of real interest rates; in this respect, most of the capital inflow consisted of short-term liquid assets rather than outlays for construction of new plant [on this point see Feldstein (1986)]. Parenthetically, one might also note here that in the event that capital were to flow into the United States, the exchange rate would appreciate and the trade deficit would deteriorate.

Another argument that has been directed against the finding that tax reform will raise the cost of capital is that this may overstate the role of targeted tax incentives in accounting for capital spending. However, a review of the econometric evidence supports the importance of tax incentives in raising capital formation. The view that tax incentives have had a powerful impact on capital-investment was supported by considerable econometric evidence in early studies [Jorgenson (1963, 1971), Hall and Jorgenson (1967, 1971)]. Studies using large scale simulation models of the economy also showed quite conclusively that both the investment tax credit (ITC) and depreciation under the Accelerated Cost Recovery System (ACRS) have exerted a statistically significant impact on capital formation in the United States [Sinai (1975), (1979)]. This view was questioned in several works by Chirinko and Eisner

(1981, 1982), who suggested that the impact of tax policy on business fixed investment was less marked than in previous estimates, although not statistically insignificant. Their view is powerfully rebutted in Sinai and Eckstein (1983), who present convincing econometric estimates of the effect of the ITC and ACRS on capital formation. Not only are the tax incentives statistically significant in predicting the resulting increases in capital investment, but their magnitude is fairly large. Using full simulations of the DRI model, Sinai and Eckstein (1983) conclude that the ratios of the real gain in business fixed investment per dollar of corporate tax loss are 81% for ACRS and 76% for the ITC. Other studies [e.g., Feldstein (1982)] have also concluded that tax incentives have had a major impact on capital spending.

Studies examining the effect of the ERTA tax changes on the actual behavior of capital investment during the 1983-85 recovery have also found that the impact was substantial. Sinai, Lin and Robins (1983), who are able to look only at the anteceding recessionary period due to data limitations, find that ERTA mitigated the decline in economic activity--and in capital formation in particular--by significant magnitudes. Using the DRI model, they conclude that with 1980 tax laws still in effect, the 1982 decline in GNP would have been more than a percentage point higher than what actually took place with ERTA in effect. Sahling and Akhtar (1984) use the Federal Reserve and Bureau of Economic Analysis (BEA) models of the economy in order to simulate the effects of ERTA. They find that ERTA accounted for at least 20% of the total increases in investment in 1983-84. When indirect feedback effects are taken into consideration, the effects of ERTA are found to have been somewhat greater. A further study by Boskin (1985) finds that roughly 25% to 30% of the aggregate increase in business fixed investment in 1981-84 was accounted for by ERTA. More recently, Feldstein and Jun (1986) have analyzed the implications of the ERTA business tax provisions. The finding is that ACRS raised the gross investment share of GNP to 13.0% in 1985, the highest level for the postwar period, while the net investment ratio rose to 4.0%, also a postwar record, and well above the previous cyclical peak of 3.7% in 1979. The maximum potential real net return on investment also rose to a postwar peak in 1982-85, and was sufficiently high that it more than compensated for high real borrowing costs.

In sum, the evidence is overwhelming that the ACRS depreciation reform and the ITC have exerted a large and statistically significant impact on capital formation. The conclusion, also corroborated in extensive empirical testing using state-of-the-art econometric procedures, is that the loss of provisions would sharply raise the cost of capital. Although the precise effects on the trade deficit are difficult to measure, common sense leads to the conclusion that the overall effects would be adverse. An increase in the cost of capital would prevent or hamper new investment in new technologies that could provide American corporations with comparative advantages in world trade. At the very least, they will slow down investment in productivity-enhancing machinery, raising the risk that American corporations will lose market share to corporations in foreign countries that do not face the same kinds of disincentives to new investment.

A further, ancillary implication should also be noted here. There would be a large and deleterious effect on capital investment in the United States. Recent simulations by NAM making favorable assumptions with respect to an offsetting monetary reflation indicate that real business fixed investment will contract by more than -3% in 1987, with the largest declines coming in equipment. Other econometric studies have reached similar conclusions. Simulations using the Washington University model find a contraction in capital spending of -17% relative to current law over six years. As above, therefore, the implications of the increased capital cost for trade should not be considered in isolation, but rather as part of the wider economic picture. Expressed in terms of the total magnitude of the output losses, the contraction in GNP resulting from declining investment spending represent a serious problem.

2.5 Other Cost Effects

While the increase in the cost of capital represents an unambiguous outcome of tax reform, other cost effects are somewhat nebulous, due to the extent to which they are dependent on cyclical factors. All other things being equal, tax reform lowers productivity growth through the capital-labor ratio, thereby raising unit labor costs. Further, because of the increase in the cost of capital relative to labor costs, the economy undergoes a shift in the mix of inputs from capital to labor. Because tax reform tends to favor services at the expense of manufacturing, service employment would increase relative to current law. Greater labor-intensity in turn will tend to put upward pressure on wages. This effect, however, is longer-term in nature, inasmuch as in the short run wages will be held back by high unemployment.

It is therefore possible to generate scenarios in which short-term non-capital costs either rise or fall relative to current law under tax reform, the key variable here being the unemployment rate. However, to the degree that any rise in unemployment would be cyclical and therefore transitory, the longer-run implications of tax reform would tend to be unfavorable for inflation. Lower productivity growth and greater labor-intensity would cause the trajectory of unit labor costs to diverge above its current law path.

III. MICROECONOMIC FACTORS

3.1 Introduction

In contrast to macroeconomic theory, the various microeconomic factors that may impact on trade performance do not form an integrated paradigm, but rather consist of several diverse ideas. While a systematic overview of possible causal mechanisms is precluded by the constraint of space, the following factors have periodically been cited as influencing the economy's competitive position, 1) possible efficiency gains resulting from the removal of tax distortions;

2) possible changes in individual behavior resulting from the lowering of marginal tax rates;

3) decreases in corporate profitability and liquidity resulting from increases in effective tax rates;

4) possible off-sourcing of production in order to take advantage of better tax provisions overseas.

3.2 Efficiency Gains

One of the most frequently articulated arguments in support of tax reform is that the removal of distortions caused by governmentally mandated investment incentives will lead to improvements in the efficiency of resource allocation. Some writers have drawn far-reaching conclusions from this claim. The advocates of tax reform, have claimed that tax reform is likely to raise the growth rate of the economy. This conclusion is diametrically opposed to that of any number of econometric studies, including the cited works by Chase and Lawrence Meyer and Associates, all of which show growth rates significantly lower than under current law.

On closer examination, there are a series of difficulties with the efficiency argument. First, it is by no means clear what is the optimal measure of efficiency, and in this regard some of the authors who have articulated this position appear to be defining efficiency tautologically. For instance, in several pieces, the authors implicitly define efficiency in terms of the operation of the market process without government interference. Using a definition of this type, it is obvious (in fact almost true definitionally) that the removal of targeted incentives would raise efficiency. However, this reasoning does not lend itself to empirically valid propositions. In other respects also, the claims of greater efficiency rest on models which are biased in favor of this finding. Works by Hendershott (1986), Fullerton and Henderson (1986) and Majd and Myers (1986) all consist of exercises in pure theory which seem predisposed to finding the conclusion of greater efficiency without, however, providing any empirical evidence that this would be the case.

A related argument is that tax reform will encourage money to be diverted away from unproductive tax shelters and invested in more productive activities. However, this is by no means clear since the sectors that are the most heavily penalized by tax reform are capital equipment and machine tools, which are highly productive. While less money would be invested in real estate and other shelters, the magnitude of the resulting investment gains is difficult to measure exactly. Nevertheless, in view of the large losses in output from lower investment expected as a result of tax reform, it is doubtful whether the efficiency gains could be sufficient to counterbalance efficiency losses due to declining capital spending. Moreover, there is little evidence that money currently invested in tax shelters would necessarily find its way into trade-related activities, making this argument essentailly irrelevant to competitiveness.

The philosophical underpinnings of this argument have a long history in neo-classical economics, but rely on assumptions that all government intervention is necessarily harmful to the private economy. While much regulation produces distortions in market processes, there are circumstances in which governmental support for industry may actually raise aggregate economic efficiency. For instance, the extensive industrial policies practiced by nations such as Japan and South Korea contributed at least to some extent to their rapid economic growth and their specialization in exports of manufactures. In a similar way, there is considerable evidence that the ITC and the successive reforms of the depreciation system in the United States, culminating most recently in ACRS, contributed to statistically significant increases in capital formation, productivity, and industrial production. If productivity is interpreted as a measure of aggregate economic efficiency, then it is readily apparent that targeted investment incentives have raised efficiency, while the econometric simulations which have demonstrated lower productivity growth under tax reform strongly suggest that removal of these provisions would lower efficiency.

Ultimately, the debate over efficiency can only be resolved as a question of empirical magnitudes. It is difficult to achieve this inasmuch as the advocates of the increased efficiency argument have not yet provided a system of measurement for testing their hypothesis. In the absence of greater evidence, at this stage one has to conclude that given the large magnitudes of the contraction in the capital stock demonstrated by econometric simulations, the efficiency losses resulting from decreased investment would be considerably greater than any possible efficiency gains.

3.3 Changes in Individual Behavior

One of the arguments made on behalf of tax reform is the same case made in support of the ERTA marginal individual tax rate reductions—that they will generate changes in individual behavior leading to increases in labor supply, higher savings and greater entrepreneurialism. It should be noted here that of these alleged benefits, increases in labor supply would not improve trade performance. Higher savings would improve the trade balance, albeit more by reducing consumption of imports than by raising investment through the familiar IS identity. Greater entrepreneurialism could plausibly affect the trade balance if the entrepreneurs specialize in tradables, but it should be borne in mind that net new business formation is not correlated with the trade performance. Further, many nations that are not noted for entrepreneurialism but rather tend to be characterized by large bureaucratic corporations (e.g., Japan and Germany) have maintained very favorable trade surpluses.

Whatever the relevance of changes in individual behavior to trade competitiveness, it is highly questionable whether the rate reductions embodied in tax reform will modify behavior to the extent claimed by its advocates. The original "supply side" case as to the alleged incentive effects associated with marginal tax rates was based largely on anecdotal evidence that paid too little attention to mitigating factors. The few attempts by supply siders to test this propositions through accepted statistical methods have yielded at best only equivocal results and have in certain instances actually disproved the hypotheses [see Dhrymes (1985)]. Econometric tests by Eckstein (1980) find only a minute response of labor supply to individual tax rates. More recent studies [e.g., Chimerine and Young (1986)] find that the elasticities of labor supply and savings to tax rates are exceedingly small. The impressionistic evidence since 1981 has tended to corroborate this skepticism, inasmuch as the ERTA rate reductions were contemporaneously associated with decreases in the savings rate and slower growth in labor force participation, although other factors were also involved here. Under the circumstances, the claim that tax reform will generate a miraculous outpouring of individual savings and work effort is superficial at best, and the further claim that this will improve the trade deficit must be dismissed as metaphysical conjecture.

3.4 Taxation of Consumption and Income

While the advocates of tax reform ascribe considerable significance to changes in marginal individual tax rates and removal of putative distortions, they have failed to address one key element in the current tax code, the extent to which the current tax system rewards consumption and penalizes saving and investment. The chief cause of this distortion is that the tax system in the United States derives most of its revenue from taxation of income rather than consumption.

This is particularly true for the Federal government, which raises virtually all of its revenue from taxes on individual income and corporate profits; social security taxes are just another form of income tax, and more importantly, tax the cash flow of corporations rather than their profits. Although the state and local governments do tax consumption, the ratio of consumption to income taxes in the United States is considerably higher than in other industrial countries. Of total revenues received by the Federal, state and local governments in 1981, some 46.2% was derived from income taxes while only 17.6% was derived from consumption taxes (the remainder is comprised primarily by social insurance contributions). By comparison, the proportions are substantially more weighted toward consumption in other industrial countries. The share of revenues derived from consumption taxes in 1981 ranged from 28% in Italy to 35% in Germany, 35% in France and 33% in Canada. Similarly, the share of revenues derived from income and profits taxes in the other industrial countries has typically been much lower than in the United States. For instance, in Germany, 29% of revenues are derived from personal income taxes and 5% from corporate taxes (a total of 34%), while in France 13.3% are derived from personal income taxes and 5% from corporate profits, a total of 18.3%.

Further, there is an inverse relationship between the propensity to tax income and the personal savings rate. Of the countries listed above the savings rate for the period 1977-79 was only 6.2% in the United States, compared to 15.0% in Austria, 14.1% in Italy, 14.0% in Germany, 13.5% in the Netherlands, 13.1% in France, 11.7% in Belgium and 11.4% in Canada. While other factors also determine savings rates, the tax system in the United States has repeatedly been demonstrated to be partially responsible for the low savings rate in this country.

The failure of any of the tax reform proposals to address the problem of excessive taxation of income relative to consumption represents a major shortcoming. In essence, while reform purports to achieve greater neutrality across sectors, it is not neutral on the consumption-income issue. Tax reform further skews the tax base toward income, and in this sense can be viewed as an implicit consumption subsidy. The logic underlying the claim that further subsidies to consumption can improve economic efficiency and generate massive increases in individual saving, work effort and entrepreneurialism must inevitably remain obscure to the unbiased observer. Moreover, the experience with consumption taxes in other countries is that they have tended to discourage imports both by lowering consumption and by raising import prices.

3.5 Corporate Profitability

Because tax reform redistributes tax liabilities from individuals to corporations, it will tend to lower real corporate profitability relative to current law. The effects will be exacerbated in the event that tax reform generates a downturn in the economy since in this instance the normal cyclical deterioration in profitability will be added to the burden of increased taxation.

One caveat must be mentioned here. Given the way in which corporate earnings are measured in the national income accounts, tax reform would tend not to affect the category designated after-tax profits, but would seriously reduce the category designated corporate cash flow, which includes the inventory valuation and capital consumption adjustments. This distinction is not merely a question of semantics, inasmuch as both the erosion of real profits during the 1970s and the improvement in real profits since 1982 were caused to a large extent by the IVA and the CCA. During the 1970s, the effective corporate tax burden tended to increase due to two mechanisms, overvaluation of inventory profits and understatement of depreciation. The decline in inflation during the early 1980s mitigated both of these factors, but the main item responsible for the improvement in real profitability was ACRS, which worked primarily through the capital consumption adjustment.

In essence, tax reform would affect real after tax profitability through two channels. Corporate profits would be raised by lower rates but this would be mitigated by the loss of the ITC and by other provisions. Corporate cash flow would deteriorate because the imposition of the minimum tax effectively limits ACRS deductions. When the two effects are combined, tax reform entails a massive redistribution of funds away from the corporate sector. The static revenue estimates prepared by the architects of the tax reform bill indicate a transfer of about $120 billion over five years. And, as noted above, the magnitude of the decline in profitability would tend to be worse in the event that tax reform were to produce a downturn in the business cycle.

Although the implications for trade are rather indirect, they are unambiguously negative. Decreases in corporate cash flow will inhibit investment and R&D, both of which would tend to enhance the competitive position of American industry. Moreover, on a sectoral basis, the greatest share of the reduction in profitability will take place in capital-intensive manufacturing, which has experienced the longest benefits from ACRS, but which is also substantially more vulnerable to import penetration. By comparison, tax reform raises real after tax profits primarily for services and other sectors which are not capital-intensive. However, services are less vulnerable to import penetration, and in fact the United States has consistently maintained an external surplus on its service account. When the sectoral distribution of tax increases and tax reductions is considered, it becomes apparent that tax reform will reduce the real profitability of firms that are particularly sensitive to imports, thereby exacerbating the likelihood of further losses in market share to foreign suppliers.

3.6 Off-sourcing of Production

A final issue to be considered is whether tax reform will entail greater outmigration of business from the United States. There is some econometric evidence that tax policy has been one determinant of the international movement of capital, although other factors have also been involved. A study by Boskin and Gale (1986) concludes that direct investment abroad is very sensitive to the after tax rate of return both abroad and in the United States. According to these simulations, a 10% change in the differential in net after tax rates of return between the United States and foreign countries increases direct investment abroad by a somewhat larger magnitude, approximately 12%. Furthermore, an increase in the rate of return in the United States will stimulate additional domestic investment, while reducing investment overseas.

The finding that tax reform will lower the real rate of return on capital investment in the United States has already been noted. With respect to the relative tax advantage of investment in the United States and overseas, a study by Arthur Andersen & Co. indicates that the loss in depreciation deductions and of the ITC would significantly worsen the domestic tax treatment of investment relative to tax treatment of investment in foreign countries. While the United States currently enjoys one of the better depreciation systems among the industrial countries, the loss of the ITC and the reduction of ACRS deductions would leave this country with one of the least favorable tax treatments of capital assets of all the industrial nations. Under the circumstances, the likelihood of a significant increase in the movement of business abroad is correspondingly enhanced. This will lead to greater off-sourcing of production and reexport to the United States, further undercutting the balance of trade.

IV. CONCLUSION

While substantial methodological and empirical issues remain to be resolved in the analysis of the effects of tax reform on trade competitiveness, the preliminary prognosis is that the implications will be highly unfavorable.

In a macroeconomic sense, tax reform will raise the consumption share of GNP, stimulating additional demand for imports, and will significantly raise the user cost of capital. Tax reform may also raise unit labor costs due to losses in productivity. While these effects could be negated if tax reform simultaneously produces a faster depreciation of the dollar, there are other ways of devaluing the dollar (e.g., monetary reflation) which would do less damage to the domestic capital sector.

In a microeconomic sense, the evidence is that tax reform will generate sufficient efficiency gains to offset efficiency losses resulting from lower investment. Claims that tax reform will stimulate additional saving, work effort and entrepreneurialism by individuals are equally unfounded, and there is little evidence that these factors would have any demonstrable effect on the trade deficit in any case. In terms of influencing individual decisions with respect to saving and investment, tax reform merely exacerbates the existing pro-consumption bias in the tax code. Meanwhile, corporate profitability will be reduced, and business will be encouraged to move overseas in order to take advantage of better tax treatment of investment abroad.

On all these grounds, the trade deficit is likely to deteriorate relative to current law. The only issue that remains to be resolved is one of empirical magnitudes, i.e., the volume of losses in net exports that will result from the tax reform initiative.

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Representative OBEY. Thank you very much. Mr. Summers, please proceed.

STATEMENT OF LAWRENCE H. SUMMERS, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. SUMMERS. Thank you. I, too, am pleased to have the opportunity to testify on the tax bill.

Several weeks ago I wrote that if one graded the tax bill, one would give it a C for simplicity, a B for growth, and an A for fairness. Readers of my reasons concluded, however, that grade inflation must have run rampant at Harvard.

Today, I want to make three points in my testimony. First, the conference committee bill taken as a whole will make the tax system more just and fair. It is worthy of your support.

Second, the business tax changes contained in the bill, particularly the abolition of the investment tax credit, will have adverse effects on economic growth in the coming years. Serious consideration should be given to enhancing investment incentives.

Third, the most pressing item on the tax policy agenda at present is the need for increased revenue to reduce Federal deficits. This is the most important step that Congress can take to increase international competitiveness. Let me take up each of these three points in turn.

First, as regards tax fairness, the conference committee bill goes a long way toward making the tax system fairer and more equitable. A major accomplishment is the removal from the tax rolls of millions of taxpayers with incomes below the poverty line.

The conference committee bill also makes great progress in enhancing tax equity by attacking tax shelters. Most importantly, it limits the ability of individuals to deduct losses from passive investments, such as tax shelter partnerships, against other income. This means that it will no longer pay for individuals to make investments whose principal benefit is that they provide more tax deductions than taxable income.

Stiffer minimum taxes on both individuals and corporations in the bill will avoid the demoralizing spectacle of affluent citizens who do not pay any income taxes. And the restrictions on special tax breaks that have long benefited certain industries will make the tax system both fairer and more efficient.

The experience of the last 2 years demonstrates that it is possible for the political process to stand up to special interests. This was feasible probably because many interests were taken on at once, making it possible to forge a large coalition for the public interest in support of a laudable objective of broadening the tax base and reducing rates.

If in the future tax breaks for specific industries are considered on an ad hoc basis, it will be difficult to protect the accomplishment represented by the conference committee bill. For the next several years, Congress should strongly resist efforts to reopen debate over tax details. On the microeconomic level, we should strive to maintain—for a change—stability in the Tax Code.

While I believe that the conference committee bill contains many provisions which on a microeconomic basis improves our tax system, there is one aspect of the bill which seriously concerns me in terms of its macroeconomic impact. By abolishing the investment tax credit and scaling back accelerated depreciation, the bill will raise the cost of capital and reduce productivity enhancing investment in new equipment. This is likely to have significant adverse consequences for economic growth over the next two decades.

My judgment is that the adverse impact of reduced investment incentives will far exceed the rather speculative neutrality benefits stressed by proponents of tax reform.

The conference committee bill will increase total corporate tax liabilities by about $125 billion over the next 5 years, largely because of the abolition of the investment tax credit. This represents an increase of more than one-fourth in corporate tax liabilities. But this figure substantially understates the adverse impact that the tax bill will have on investment. The tax bill would raise much more in corporate revenues but for the fact that the corporate rate is reduced from 46 to 34 percent. This rate reduction of the corporate tax rate has the primary effect of reducing the tax rates on the profits that firms will earn in coming years on investments that they have made in the past.

On the other hand, even the most zealous supply-sider must acknowledge that reductions in the tax rate on old capital cannot create more of it. On the other hand, the revenue raising features of the conference committee bill—especially the abolition of the investment tax credit and changes in depreciation rules—will have their primary effect on new investments where incentives have potent effects.

In an important sense, the conference committee bill is perverse. It simultaneously reduces the tax rate on old capital while raising it on new capital. Tilting the playing field toward yesterday in this way is favored by entrenched firms now reaping the benefit of past investments. They will receive windfall gains as their tax rate falls and the tax burden on potential competitors is increased.

I would interject that I had the experience a year or so ago of speaking with executives from a large hotel chain who explained that they had been enthusiastic about the accelerated depreciation put into effect in 1981 because they built hotels and they thought it would benefit them. What they didn't figure on was that in large part they already owned a lot of hotels and that the principal effect of the provision was to enable others to enter the industry, compete with them, make the market more competitive, bring down prices, and reduce their profits.

In the same way, this bill goes in the opposite direction and makes it more difficult for new firms to enter industries and compete with firms that are already entrenched there.

It is frequently suggested that this policy of reducing the corporate tax rate and increasing investment incentives will increase neutrality. But it's my view that these arguments do not stand up to close scrutiny. Let me take up just one point and I could elaborate later.

It is suggested that current law somehow favors capital-intensive industries and that this favoritism will be undone by tax reform.

This is largely a misconception. Investments in intangibles—research and development, advertising, marketing or goodwill—all currently receive the ultimate in accelerated depreciation, expensing. Although these outlays yield a stream of benefits over time, just like capital investments, firms are permitted to write them off in the year they are undertaken.

For example, the large expenditures incurred by Coca-Cola in developing and marketing New Coke can all be expensed.

In contrast, outlays on physical capital are necessarily amortized over time. The resulting tax bias in favor of intangible investments has until now been partially mitigated by the investment tax credit and accelerated depreciation. It will be exacerbated by the conference committee bill which scales back these investment incentives.

No one can accurately predict the consequences of the tax bill for business investment decisions. But some suggestive estimates are possible. The conference committee bill would have the effect of raising the cost of capital by at least 10 percent. My reading of the econometric evidence suggests that in the long run this will lead to a reduction of between 10 and 15 percent in the stock of plant and equipment which will, in turn, translate into a reduction of at least 3 percent in the economy's potential output.

Beyond the direct effect of reduced capital accumulation, it is likely that reductions in capital investment will slow the rate of technical progress, thereby reducing our growth rate. This indirect effect could easily reduce real GNP 10 years from now by another 2 or 3 percent. Combining these two effects, a reasonable estimate—and I share all Alan Greenspan's doubts about the ability of anybody to predict what will happen accurately—is that the conference committee bill will reduce real GNP in 1996 by up to 5 percent.

Concerns about the adverse effect of the tax bill on investment will take on increased urgency if, as many fear, growth continues to languish or the economy slips into recession. Serious consideration should be given to reinstituting the investment tax credit in the near future, especially if investment spending does not rebound with the resolution of tax reform uncertainties. Reintroduction of the investment tax credit or acceleration of depreciation allowances, even if funded by an increase in corporate and individual tax rates, would provide much needed economic stimulus over the next several years.

Finally, the third point in my testimony is the deficit problem. The conference committee bill was designed to be revenue neutral. There is a good chance that it will in fact lose revenue. There is an inevitable tendency in revenue estimation to assume that behavior will not change, or will change relatively little, when tax rules are altered. In fact, the tax bill will drive households out of tax shelters and consumer debt. This is all to the good, but it does mean that the revenue gains from limitations of these deductions will be less than those that are forecast.

This is unfortunate. Only through reductions in the Federal deficit will it be possible for us to achieve the twin goals of rapid productivity growth and increased international competitiveness.

A fundamental identity—one of the few things economists all agree on because it's totology—holds that the Nation's trade balance is just equal to the difference between our level of national saving and our level of national investment. When investment exceeds savings, we must borrow from abroad and that means we must import more than we export. Conversely, if we wish to reduce our trade balance, we must either increase savings or reduce investment.

The tax bill, as I've argued, may actually improve competitiveness, but in a perverse way by reducing investment.

What we want to do, if we want to promote both savings and investment, to increase both investment and international competitiveness, is to increase national savings. There is no alternative. Without changes in national savings, increases in investment must be financed from abroad and so must come at the expense of improvements in our trade balance.

Seen in this light, the clear priority for economic policy in the next few years is to raise our national savings rate. The conference committee bill does little to increase national savings. It may increase public dissaving through larger budget deficits. It will probably reduce private saving because of the curtailment of IRA's and the reductions in after-tax corporate profits. Thus, it lacks the potential to solve capital formation and competitiveness problems simultaneously. The best way of addressing these problems would be tax measures to increase revenues and reduce deficits. These could take the form of either rate increases under the income tax or new taxes on consumption.

In considering these two alternatives, it would be well to keep in mind that new taxes on consumption would have the substantial virtue of making revenue available to finance the reinstitution of important investment incentives and they are worthy of serious and prompt consideration.

[The prepared statement of Mr. Summers follows:]

PREPARED STATEMENT OF LAWRENCE H. SUMMERS

Summary

1. The Conference Committee tax bill enhances the fairness of the tax system in many ways. By removing millions of poor taxpayers from the tax rolls and limiting tax shelters in a variety of ways it will enhance both actual and perceived tax justice. This is a major accomplishment which should be preserved as Congress considers future tax changes.

2. The major defect of the Conference Committee bill is that it raises the tax burden on new investment. The bill contains a number of provisions, most importantly the abolition of the investment tax credit, which would raise the cost of capital and significantly reduce productivity-enhancing capital investment. These adverse effects will not be fully mitigated by the reduction in corporate tax rates, which will largely benefit investments that have already been put into place. The adverse effects of reduced investment on economic growth are likely to dwarf any gains from increased neutrality. Particularly if the current economic expansion continues to languish, the investment tax credit should be reinstituted.

3. The Conference Committee bill does little if anything to address our most urgent economic problem--increasing national savings. Without increases in national savings, it will be impossible to realize the twin goals of rapid productivity growth and increased international competitiveness. Action to reduce Federal deficits through tax increases should be an immediate priority in tax legislation. Serious consideration should be given to new consumption taxes.

My name is Lawrence Summers. I am a professor of economics at Harvard University. I welcome this opportunity to testify before the Joint Economic Committee on the vitally important topic of tax policy at this crucial juncture. While the Conference Committee bill improves the tax code in many ways, it is flawed in some important respects and fails to address certain urgent economic problems. Despite the two years of hard work that are about to culminate in a new Internal Revenue Code there will be a continuing need in coming years for the Congress to make tax policy decisions.

In my testimony today, I will make three points. First, the Conference Committee bill taken as a whole will make the tax system more just and fair. It is worthy of your support. Second, the business tax changes contained in the bill, particularly the abolition of the investment tax credit, will have adverse effects on economic growth in coming years. Serious consideration should be given to enhancing investment incentives. Third, the most pressing item on the tax policy agenda at present is the need for increased revenues to reduce Federal deficits. I will take up these points in turn.

Tax Fairness

The Conference Committee bill goes a long way toward making the tax system fairer and more equitable. A major accomplishment is the removal from the tax rolls of millions of taxpayers with incomes below the poverty line. The increases in the personal exemption contained in the bill are long overdue. The fact that the personal exemption will be indexed insures that any future inflation will not erode the value of these increases. The phase out of the exemptions for high income taxpayers is desirable as it permits the granting of substantial tax relief to the poor without undue losses in revenue.

The Conference Committee bill also makes great progress in enhancing equity by attacking tax shelter investments. Most importantly, it limits the ability of individuals to deduct losses from passive investments, such as tax shelter partnerships, against other income. This means that it will no longer pay for individuals to make investments whose principle benefit is that they provide more tax deductions than taxable income. While the provisions limiting the deductability of tax losses will necessarily be complex, they are worthwhile because of the very substantial symbolic importance of preventing high income taxpayers from escaping taxation.

The tax reform bill also contains many other provisions attacking abusive practices that have permitted some sophisticated and wealthy individuals and corporations to avoid bearing a tax burden commensurate with their income. The proposed increases in the capital gains tax will make "tax arbitrage" investments of the kind that are very common today less attractive. The stiffer minimum taxes on both individuals and corporations will avoid the demoralizing spectacle of affluent citizens who do not pay any income taxes. And the restrictions on special tax breaks that have long benefitted certain industries will make the tax system both fairer and more efficient.

The experience of the last two years demonstrates that it is possible for the political process to stand up to special interests. This was feasible only because many interests were taken on at once, making it possible to forge a large coalition for the public interest in support of the laudable objective of broadening the tax base and reducing rates. If in the future, tax breaks for specific industries are considered on an ad-hoc basis it will be difficult to protect the accomplishment represented by the Conference Committee bill. For the next several years, Congress should strongly resist efforts to reopen debate over tax details. On the microeconomic level, we should strive to maintain (for a change), stability in the tax code.

The Investment Incentive Problem

While I believe that the Conference Committee bill will in a number of respects make the tax system fairer and more efficient, there is one aspect of the bill which seriously concerns me. By abolishing the investment tax credit and scaling back accelerated depreciation, the bill will raise the cost of capital and reduce productivity enhancing investments in new equipment. This is likely to have significant adverse consequences for economic growth over the next two decades. The adverse impact of reduced investment incentives will far exceed the rather speculative neutrality benefits stressed by proponents of tax reform.

The Conference Committee bill will increase total corporate tax liabilities by about $125 billion over the next five years. This represents an increase of more than one-fourth in corporate tax liabilities. But this figure substantially understates the adverse impact that the tax bill would have on investment. The tax bill would raise much more in corporate revenues but for the fact that the corporate rate is reduced from 46 to 34 percent. This rate reduction has the primary effect of reducing the tax rates on the profits that firms will earn in coming years on investments that they have made in the past.

Even the most zealous supply sider must acknowledge that reductions in the tax rate on old capital can not create more of it. On the other hand the revenue raising features of the conference committee bill--especially the abolition of the ITC and changes in depreciation rules--will have their primary effect on new investment, where incentives have potent effects.

In an important sense, the Conference Committee bill is perverse. It simultaneously reduces the tax rate on old capital while raising it on new capital. Tilting the playing field towards yesterday in this way is favored by entrenched firms now reaping the benefit of past investments. They will receive windfall gains as their tax rate falls and the tax burden on potential competitors is increased. However, the arguments made on public policy grounds by those favoring reductions in investment incentives do not stand up under close scrutiny.

The combination of reduced investment incentives and a reduced corporate tax rate embodied in the Conference Committee bill is often defended on grounds of neutrality. It is suggested that current law somehow favors capital intensive industries and that this favoritism will be undone by tax reform. This is a fundamental misconception. Investments in intangibles--research and development, advertising, marketing or good will--all receive the ultimate in accelerated depreciation, expensing. Although these outlays yield a stream of benefits over time, just like capital investments, firms are permitted to write them off in the year they are undertaken. For example, the large expenditures incurred by Coca-Cola in developing and marketing New Coke can all be expensed. In contrast, outlays on physical capital are necessarily amortized over time. The resulting tax bias towards intangible investment has until now been partially mitigated by the ITC and accelerated depreciation. It will be exacerbated by the Conference Committee bill which scales back these investment incentives.

It is often argued that investment incentives should be scaled back because they do not work. This is not a fair reading of recent history. We have lived through a period of unprecedentedly high real interest rates, large Federal deficits and increasing foreign competition. Almost any observer asked to predict the consequence of this combination for investment, would have predicted that it would be very sharply curtailed. Yet, at least until recently when concerns about tax reform have had important effects, business fixed investment has proven remarkably robust during the current recovery and has actually been stronger than would be predicted from normal cyclical relationships. Indeed the share of gross business fixed investment in GNP reached its post-war high in 1985. The strength of business investment reflects many factors, but most economists agree that the tax incentives enacted in 1981 deserve at least some of the credit.

No one can accurately predict the consequences of the tax bill for business investment decisions. But some suggestive estimates are possible. The Conference Committee bill would have the effect of raising the cost of capital by at least ten percent. In the long run this will lead to a reduction of between 10 and 15 percent in the stock of plant and equipment. This in turn will translate into a reduction of at least 3 percent in the economy's potential output. Beyond the direct effect of reduced capital accumulation, it is likely that reductions in capital investment will slow the rate of technical progress, thereby reducing our growth rate. This indirect effect could easily reduce real GNP 10 years from now by another 2 or 3 percent. Combining these two effects, a reasonable estimate is that the Conference Committee bill would reduce real GNP in 1996 by up to 5 percent.

This estimate translates into a reduction of about one half of one percentage point per year in the economy's growth rate. At this point, we can ill afford any reduction in economic growth. To highlight just one of the consequences of reduced economic growth, a reduction of one half of one percent per year in the economy's growth rate would raise the 1991 Federal budget deficit by almost $50 billion.

Concerns about the adverse effect of the tax bill on investment will take on increased urgency if, as some economists fear, growth continues to languish or the economy slips into recession. Serious consideration should be given to reinstituting the investment tax credit in the near future especially if investment spending does not rebound with the resolution of tax reform uncertainties. Reintroduction of the ITC or acceleration of depreciation/ allowances, even if funded by an increase in corporate and individual tax rates, would provide much needed economic stimulus over the next several years.

The Deficit Problem

The Conference Committee bill was designed to be revenue neutral. There is a very good chance that it will in fact lose revenue. There is an inevitable tendency in revenue estimation to assume that behavior will not change when tax rules are altered. In fact the tax bill will drive households out of tax shelters and consumer debt. This is all to the good, but it does mean that the revenue gains from limitations of these deductions will be less than those that are forecast. My guess, but it is only a guess, is that the tax bill will reduce revenues by as much as $20 billion a year by 1990. It is clear that it will not contribute to the solution of the Federal deficit problem. This is unfortunate. Only through reductions in the Federal deficit will it be possible for us to achieve the twin goals of rapid productivity growth and increased international competitiveness.

A fundamental economic relationship holds that the nation's trade balance is just equal to the difference between national saving and investment. When as has been the case in recent years, investment exceeds savings, we must borrow from abroad. The mirror image of our rising capital account surplus as funds flow in to the country must arithmetically be a current account deficit. We must export less than we import. The economic mechanism here is simple. Capital inflows raise the demand for dollars, increasing our exchange rate. This in turn makes American producers of tradeable goods less competitive on world markets.

The savings-investment identity I have just explained has an immediate and important consequence. The only way in which we can raise both investment and international competitiveness simultaneously is to increase national savings. There is no alternative. Without changes in national saving, increases in investment must be financed from abroad and so must come at the expense of improvements in our trade balance. Reductions in the flow of funds from abroad that bring the dollar down and improve our trade balance will necessarily lead to higher interest rates and reduced investment. Seen in this light, the clear priority for economic policy in the next few years is to raise our national savings rate.

The Conference Committee bill is unlikely to increase national savings. As I have already observed, it may increase public dissaving through larger budget deficits. It will probably reduce private saving because of the curtailment of IRAs and the reductions in after-tax corporate profits that it will cause. Thus it lacks the potential to solve both the capital formation and competitiveness problems. The best way of addressing these problems simultaneously would be tax measures to reduce deficits. These should take the form either of rate increases under the income tax or new taxes on consumption.

New taxes on consumption would have the substantial virtue of making revenue available to finance much needed investment incentives. They would also have rather more revenue potential than would further income tax reform. They are worthy of serious and prompt consideration.

Representative OBEY. Thank you. Mr. Eisner, please proceed.

STATEMENT OF ROBERT EISNER, WILLIAM R. KENAN PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY

Mr. EISNER. Thank you very much. I'm delighted to be here. I guess it might be said that with 6 economists testifying you will have at least 12 sets of opinions, but I will say that I agree with a fair amount of what's been said before. I agree with Alan Greenspan and his suggestion that the revenue estimates are certainly uncertain. Indeed, I think revenues are notoriously uncertain anyway, whether you change a tax bill or not. I agree with him that subsidies for investment tend to give you inefficient investment.

Where I'm going to most sharply disagree with those who have preceded me is on their reaction to investment incentives and whether the loss of some of them is really going to do any damage.

I might say that the tax reform legislation now before Congress is a significant, if limited, step in the direction of horizontal equity—fairness, as Larry Summers has been suggesting—and a more level playing field for economic decisions.

By lowering marginal tax rates, directly limiting tax shelters through restriction of the application of passive tax losses, eliminating the investment tax credit, including all of capital gains in taxable income, and somewhat reducing tax depreciation deductions, the current reforms will cause economic decisionmakers to focus more on productivity and returns in the marketplace and less on tax considerations.

Widely voiced concerns—and you've heard them here this morning—that the removal of so-called "investment incentives" will adversely affect capital formation, productivity, and international competitveness are without foundation.

First, there is considerable evidence that these tax incentives do very little for the aggregate of investment. My own studies suggest that each lost dollar of tax revenues from the most effective of investment incentives gains at most 40 cents of added investment. This stems from studies I did for the Treasury which have been published now in a number of places back in 1980 and 1981 when we were considering the tax changes, and I could analyze the data that had occurred with tax incentives that we had had in the past.

I believe that taking all the repercussions into account, the investment gains are considerably less, possibly close to zero. But what is worse, as has been suggested—and I don't think some of the panel recognize the seriousness of this—the investment that is stimulated is that which was not sufficiently profitable or productive to be undertaken without the tax incentives. Such investment is not likely to be productive. If it were, it would have been undertaken with lesser or no tax advantage. The lesson of half-empty office buildings, uneconomical investment in various industries, along with generally lagging productivity growth that we have suffered with tax incentives should be clear to all.

Larry Summers indicates what he considers the desirability of having accelerated depreciation, for example, to stimulate investment in new facilities or new buildings, and he points out to the hotel chains whose concern then was diminishing the usefulness of their other properties. But is there a great advantage in stimulating investment in one area so as to make previous capital unnecessary and unuseful?

I submit that a considerable part of the problem of unemployment in the Midwest has been due to the tax advantages that have stimulated new investment elsewhere, making old investment and, therefore, the need for labor in the older regions obsolete and economically untenable.

I should add there have been studies by the Treasury that are available in the Office of Tax Analysis showing that under the current tax system we have the most outrageous differences in the profitability of investments. In various industries and types of equipment, the taxation on capital is clearly negative. The Government is paying 10, 20, 30, 40 cents on the dollar to subsidize investment—in other words, actually to put these firms in a position where certain kinds of investment clearly have negative returns without the tax advantage but are being made profitable and are being untaken, to the extent they are, by the very large tax advantages.

This uneconomic investment does not add to productivity; it decreases it. And I might emphasize that it's not clear that it does much for it. There was an article in the Wall Street Journal this morning I would recommend to all of you, "Capital spending seems stable for a year. Tax revision's negative effect is largely over." It then goes into some of the figures, and they are illuminating.

It points out that in the fourth quarter of 1985, nonresidential investment reached an annual rate of $474 million and this was some $16 billion above the total for the year and has been about $14 to $16 billion above the investment that's been undertaken in the first two quarters of this year.

Now if you reflect on those figures, that investment that was undertaken in the fourth quarter of 1985, that $16 billion bulge, is explained I think correctly as due to the anticipation that the investment credit would be rescinded. That is precisely where you can expect some effect of investment credits. When you take it on or off and firms realize that if you invest now it's profitable and you've gained a credit, while if you put it off you don't get it. And yet, with that huge effect—the fact that they could gain 10 percent on the equipment they are acquiring if they did it that last quarter, you see an increase of only $16 billion over the average. That comes down to about $4 billion for the total year, although that may be a minimum statement because some of this may be going on all through the year.

But clearly you don't get large magnitudes in the very best case where it's not a matter of getting an investment incentive you can take any time, but rather where you know if you take it now you get the benefit of it and if you don't invest now you don't get it.

I think what has happened with investment incentives to a very large extent is that they have churned things. They have induced those firms that can take advantage of them to invest somewhat more. They then have repercussions on the rate of interest, on prices of capital goods, which make it more difficult for other firms to invest, and the effect on total investment is minimal. The effect on the productivity of investment is very clearly negative.

Now to the matter of competitiveness. This is a tough one. I think Larry Summers was very correct in pointing out an identity between the capital in-flow and the current account deficit. That is an identity we all recognize. I wish all of us would try to recognize the implications of this kind of an identity for the whole matter of competitiveness and the fact that almost all the measures we're talking about—subsidies to capital-intensive industries and the like—do not change competitiveness for the economy as a whole. If you give an advantage to one industry, you make that industry more competitive, but at the expense of another industry.

The one way to make the economy more competitive internationally that is available is not through tax reform; it's through monetary policy that will drive down the value of the dollar. And the extent to which the dollar has been driven down will be very beneficial. It takes time. Economists know well there's what is called a "J" curve. At first, the repercussions are not advantageous but they come along. I should think it would be advantageous for the dollar to be driven down further.

The problem of profitable investment can also be met by monetary policy. Indeed, an easier monetary policy driving down interest rates will stimulate investment. It will improve our trade balance. It will improve our competitiveness. And that's the way to go and the economy should not be distorted by perverse tax incentives as a means of trying to meet the problem of competitiveness.

And I appreciate Mr. Jasinowski's concerns for manufacturing. That's his job and I hope I don't disturb you. Manufacturing is not all of the economy. I hope manufacturing can be competitive. I think with appropriate exchange rates it will be considerably competitive. But I believe that employment in manufacturing is about 30 percent perhaps of total employment in the economy.

I'm just back from France and I note that some of the French are quite upset. They report that 50 percent of the box office receipts in movies in Paris are now going to American movies as against perhaps 43 percent to the French. And that bothers them. But that's one of our export earnings. You can call that a service. The fact is, again, if you help one industry, you're not helping one industry against foreigners in general; you're helping one American industry at the expense of other industries.

Now I can appreciate that a Representative or Senator from a district or a State concerned with a particular industry may feel he has to vote those interests, but there can be no confusion that those interests are being voted generally at the expense of the interests of people in other industries.

Our problems of productivity require vigorous new impetus to competitive forces and investment in the social overhead capital, education and training, without which private business cannot flourish. Private investment will then take care of itself and play its proper role in a prosperous economy with adequate sources of credit and saving.

I might interpolate to note the concern expressed, at least by the tone of the remarks, that the tax reform may foster a certain labor intensity. Now there's nothing wrong with efficient labor, too. In a situation where we have still some 7 percent of the labor force unemployed, something that would increase the demand for labor, if it would, might well be good. It would increase the demand, I would hope, for investment in labor, for training of labor, for having a labor supply that can be utilized. And with a more efficient labor force—and a better utilized labor force—that again will stimulate investment.

I would then conclude—and I hope you can press me to polish the edges of what I've been saying—the reduction of the misallocation of resources due to the combination of high tax rates, tax shelters, and so-called investment incentives, can be expected to have favorable effects on real GNP and its rate of growth certainly over the long run. I join Alan Greenspan in being unable to predict exactly what will happen in the immediate short run, but there again, this isn't the end. You need a watchful eye.

I would say that remedies on stimulating the economy at this point should come from the side of monetary policy. I certainly wouldn't go tinkering with the Tax Code again to reinstitute inefficient incentives.

[The prepared statement of Mr. Eisner follows:]

PREPARED STATEMENT OF ROBERT EISNER*

The tax reform legislation now before Congress is a significant if limited step in the direction of horizontal equity and a more level playing field for economic decisions.

By lowering marginal tax rates, directly limiting tax shelters through restriction of the application of "passive" tax losses, eliminating the investment tax credit, including all of capital gains in taxable income, and somewhat reducing tax depreciation deductions, the current reforms will cause economic decision-makers to focus more on productivity and returns in the market place and less on tax considerations.

Widely voiced concerns that the removal of "investment incentives" will adversely affect capital formation, productivity and international competiveness are without foundation.

First, there is considerable evidence that these tax incentives do very little for the aggregate of investment. My own studies, after devoting much of my career to the study of business investment, suggest that at most each lost dollar of tax revenues from the most effective of investment incentives gains at most 40 cents of added investment. I believe that taking all repercussions into account, the investment gains are considerably less, possibly close to zero. What is worse, what investment is stimulated is that which was not sufficiently profitable or productive to be undertaken without the tax advantage. It is not likely to be productive. Otherwise it would have been undertaken anyway. And it tends to crowd out other, more productive investment with lesser or no tax advantage. The lesson of half empty office buildings, uneconomical investment in steel and power along with generally lagging productivity growth that we have suffered with tax incentives should be clear to all.

Uneconomic investment does not add to productivity; it decreases it. But in any event, subsidies to capital intensive industries cannot improve international competiveness for the economy as a whole. Given flexible exchange rates, subsidies that make some industries more competitive can only be at the expense of other sectors of the economy which then become less "competitive." For if we export more in one area, we increase the demand for dollars by foreigners, thus making the dollar more expensive, injuring other exports and fostering imports which compete with American products. The problem of international competiveness for the economy as a whole is in the long run certainly a problem of exchange rates. It is vital that the dollar find a level at which our imports and exports are in balance with the long run propensities of foreigners and Americans to invest at home and abroad. Our current problem can and should be relieved by an easier monetary policy, which would reduce interest rates, lower the value of a dollar and hence increase exports and decrease imports, as well as stimulate investment.

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*William R. [illegible] Professor of Economics at Northwestern University.

Our problems of productivity require vigorous new impetus to competitive forces and investment in the social overhead capital, education and training without which private business cannot flourish. Private investment will then play its proper role in a prosperous economy with adequate sources of credit and saving.

The tax reform is likely to aid those sectors of the economy that have suffered from high tax rates without major offsetting deductions. Service industries and generally less capital-intensive firms may well be favored. There is nothing bad about this. Growth and progress are not uniquely tied to heavy and expensive machinery and bricks and mortar. And the reduction in tax incentives for investment may well free capital of all kinds to those industries that have until now been less capital-intensive.

Finally, the reduction of the misallocation of resources due to the combination of high tax rates, tax shelters, and so-called investment incentives can be expected to have favorable effects on real GNP and its rate of growth.

Representative OBEY. Thank you, Mr. Eisner.

Let me do something I don't ordinarily like to do. Mr. Cooke, I apologize ahead of time, but Mr. Greenspan has a rather important meeting he has to attend which will require him to leave at 11:15. Before he does that, I would like to interrupt temporarily to ask if there are any questions from anyone at the table that they would like to direct to Mr. Greenspan before he leaves, or for that matter, I suppose I should ask first, are you moved to respond to anything that you heard any of your colleagues say?

Mr. GREENSPAN. I think it's important to emphasize the issue that Mr. Eisner was raising; namely, what the investment tax credit actually does. Let's look at investment generally.

If a particular investment has sufficient improvement implied in unit cost and/or an increase in capacity, the implied pretax rate of return will be adequately in excess of the so-called hurdle rate of return and that type of investment will be initiated with or without the investment tax credit.

The only type of investment that the investment tax credit makes a difference for are those investments which fail to have adequate pretax rate of return which means have inadequate prospective unit reduction in costs and/or increases in capacity. What we are doing when we eliminate the ITC and essentially hopefully allocate the funds for corporate tax rate cuts, is to reinforce the type of investment which is of necessity productive.

Now it's very difficult to know whether that reduces the level of aggregate investment or not, but I think it's terribly important to make a judgment between what is overall plant and equipment expenditures, capital investment—anything capitalized—and its level of productivity. There are nonproductive investments which are capital investments. We put them into the same categories as aggregate investment but they really are quite different things.

This bill, as I mentioned, is risky on a number of different issues, but I don't think that it can be argued that the investment tax credit is more than it really is.

Representative OBEY. Thank you. Let me just ask you one question before I ask either of the other gentlemen if they have a question for you.

I'm struck by the fact that so many of the witnesses have mentioned that this bill will produce, in their judgment, lower growth. Some say just short term, others say short term and long term.

Given the fact that GNP growth in the last quarter was 0.6 of 1 percent, which is pretty anemic, does that imply that if we're going to have even slower growth that we're going to be at a near recession or in a recession situation, or are you simply saying that it would reduce it below your expectations without the passage of this bill?

Mr. GREENSPAN. I think that's right, Mr. Chairman. The effects of the tax bill are already in the economy. We have had the effective rescission of the investment tax credit. Capital investment projects all through 1986 have presumed investment tax credits would not be available even though individual corporations have booked the credit in their accounting returns. I would think that at the moment much of the anticipatory activities which are relevant to this bill are already embodied in corporate decisions and to a very substantial extent in the market value of assets to which they apply.

Representative OBEY. Let me just follow up with one other question. Let's assume that next year we run into a situation in which the economy is growing no faster than it is right now, perhaps even less. If that were to happen—and it could very well happen, given the fact that according to the Labor Department private business output actually declined in the last quarter—and if people were then knocking on our doors saying, "Fellows, you need to restore more investment incentives; you ought to go back to the investment tax credit," would you think we ought to listen at that time? Or do you think we ought to try to listen to those who are saying, "For God's sake, let's leave some stability in the Tax Code for a while"?

Mr. GREENSPAN. Well, the only argument that I can consider relevant for the investment tax credit is the fact that owing to excessively high levels of Government budget deficits we probably have pushed real costs of capital above what they otherwise would have been. And to that extent, you can argue that the investment tax credit, at least in part, offsets those costs and, as a consequence, probably does create levels of investment which would not occur in today's environment, but would at lower costs of capital.

It's a highly technical argument and one which I suspect won't carry terribly much weight, but there are arguments for, in a sense, using the investment tax credit as an offset to the effects of other governmental policies.

But I do think it's a mistake to endeavor to insert direct incentives into the capital markets other than lowering the corporate tax rate. I would say any funds which were available should bring the corporate rate down rather than endeavor to assist various different types of profitmaking endeavors.

Representative OBEY. Congressman Hawkins.

Representative HAWKINS. Let me just ask, in view of the critical nature of the economy at this time, do you think this is a good time to be raising a so-called tax reform proposal?

Mr. GREENSPAN. Well, Congressman Hawkins, as I say in my prepared statement, there probably never is a good time except perhaps when the economy is moving ahead at a very rapid pace. We're not apt to be able to choose that time and I think, while the bill is highly risky for reasons which I suggested and I would much prefer to choose a different time to initiate it, it's probably now or never.

If there's a delay at this stage, my suspicion is, the bill is dead.

Representative HAWKINS. The economy we are faced with, if the bill does accomplish something that is substantial—and almost everyone has testified that in terms of growth that isn't likely to be a stimulus—what is so desirable about this particular bill at this time?

Mr. GREENSPAN. I think it has long-term positive effects in the sense that it restructures the demand and supply of capital in a manner in which we increase the emphasis on more productive types of capital investment, those that obtain rates of return on a pretax basis and don't need tax subsidies in order to initiate them.

However, over long term, probably 5, 8, maybe 10 years out, it is, in my view, a desirable structural improvement in the tax system to lower rates both individual and corporate rates and eliminate a lot of tax preferences. I must say I would have preferred that the bill were revenue neutral within both the individual and the corporate sectors by themselves, although I recognize the politics forced that in another direction.

But it's a very tough call. I would say this bill is just barely marginally desirable but solely for its long-term considerations because short-term considerations I do think are negative.

Representative HAWKINS. Do you think monetary policy would have been a better way of doing it?

Mr. GREENSPAN. I don't think monetary policy can offset the types of effects that are occurring. It's a mistake to presume that we can just merely turn the tap on monetary policy and create whatever level of economic activity we would like.

If that were the case, we should be doing a lot more now for other reasons, and I have the impression that there's less in the way of potential monetary stimulus in the longer run than I think a number of my colleagues here have indicated.

Representative OBEY. Congressman Archer, you have time for a very, very short question.

Representative ARCHER. Mr. Chairman, it's unfortunate because I've got about 20 questions to match Mr. Greenspan's anticipated 20 problems that we can't anticipate.

I guess there are several things that were not mentioned by any one of you today and I will address this to you, Alan, at this point and hope to get in some with the others later.

Something that disturbed me tremendously is the retroactivity that's in this bill. Nobody said anything about retroactivity, not a one of you.

I wonder if you have any concern about that, number one.

Number two, does it concern you that whereas historically the corporate rate has been less than the maximum individual rate, that is now in this bill significantly more than the individual rate? None of you have talked about that.

I guess because there's only a couple of minutes I'd better stop right there and not get into the other 18.

Mr. GREENSPAN. Congressman, I am concerned about the retroactive nature, especially with respect to passive losses. I think that the issue of eliminating passive losses was correct, but I think that it does raise some very serious questions about the abruptness in which it is done and the impact that it's likely to have with respect to existing limited partnerships and a number of other very significant structural investment vehicles within our particular system.

It probably would have been desirable to phase that out far more, over a much broader period of time.

Representative ARCHER. What about the relationship of the individual rate to the corporate rate?

Mr. GREENSPAN. That raises a lot of very interesting questions about general tax policy with respect to the whole question of subchapter S corporations. The nature of partnership versus corporate income is going to be a very significant question which is going to surface as a consequence of this bill. What it probably suggests is that we recognize that the partnership and individual tax rates are going to act a great deal more as capital investment incentives than in the past. I would hope that if there's pressure to close the gap that the best way to close it is to bring the corporate down, rather than the individual rate up.

Representative OBEY. Mr. Greenspan, it is a little bit after 11:15 and I know you have to go. I thank you very much for coming.

Mr. GREENSPAN. I'd also like to thank Mr. Cooke for his time. Thank you.

Representative OBEY. Now, Mr. Cooke, with the FDIC, why don't you give us all the good news as you see it?

STATEMENT OF DAVID C. COOKE, ASSISTANT TO THE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. COOKE. Good morning. I appreciate this opportunity to present the FDIC's views regarding the pending tax reform as it relates to the banking industry.

I would like to note that I've submitted a prepared statement which I'd like to summarize now.

As a matter of policy, the FDIC does not take a position on tax proposals except when we feel they will negatively affect the soundness of the banking system. With regard to the current proposal, we have focused our attention on one provision—elimination of tax deductible reserves for bad debts. Thus, my comments include only a limited review of the other provisions affecting banks.

Before addressing tax reform, I'd like to briefly comment on the condition of the banking system. Banks have been failing at records not seen since the advent of Federal Deposit Insurance. Last year's record of 120 bank failures will soon be eclipsed as 100 banks have already failed this year and we still expect another 50 before the year is over.

Despite these failures, our problem bank list continues to grow. Currently, we have classified 1,418 banks with problems, up nearly 300 from 9 months ago, and a sixfold increase since 1981.

These and other key indicators clearly show the banking industry is under significant strain and we don't foresee much improvement in the near term.

The proposed tax reform has several provisions that will directly affect banks. However, any provision that alters consumer or business decisions will also impact on banks. These indirect effects may influence a bank's sources and costs of funding, the types of investments it chooses, and the quality or value of existing investments. Some of these effects may prove to be relatively insignificant from a safety and soundness point of view. Only time will tell.

At this point, though, allow me to review those provisions we see most affecting banks directly or indirectly.

First, the good news. The proposed reduction in the corporate tax rate from 46 to 36 percent, ignoring the effects of other provisions in the tax law, could save the banking industry about a billion dollars a year. Unfortunately, this is the only aspect of tax reform which would be directly favorable to banks.

The provision of tax law that most troubles the FDIC is the elimination of bad debt reserves for a banking organization with total assets of $500 million or more. Currently, there are 398 such organizations, including 31 banks and 367 holding companies which own 2,530 banks. In all, 2,561 banks, including 104 problem banks, stand to lose their deductions for bad debt reserves. These banks, representing approximately $2.3 trillion in assets or about 80 percent of the industry's loans, will only be allowed a tax deduction when specific loans have been identified and charged off. Moreover, they will have to recapture existing reserves as income.

The FDIC from the beginning has opposed this tax change. Providing for bad debt reserves is good accounting, good business, and good banking. We and other regulators are continually encouraging banks to reevaluate their loan portfolios and adequately provide for potential losses.

Last year, net loan chargeoffs amounted to $13.1 billion or 0.8 percent of yearend loans. We have not seen a rate that high since 1936.

Moreover, the level of subquality assets has continued to grow and now stands at a record $57 billion.

In our view, anything that discourages banks from providing for losses in their loan portfolio is potentially dangerous. The elimination of the bad debt reserve deduction for large banks represents the loss of a reasonable and legitimate business expense. We see no reason for the arbitrary distinction between large and small banks. It is simply a fact for all banks that loan losses occur before they are identified. If it were otherwise, we would probably have a lot fewer bank failures.

As mentioned earlier, the proposed law would also require existing bad debt reserves to be recaptured as taxable income over the next 4 years. Our estimates indicate this recapture of loans could cost the banks as much as $4 billion in higher taxes.

To soften the impact, the tax proposal would allow certain troubled banking organizations to defer recapture of their reserves. Such organizations would be defined as those whose nonperforming assets exceed 75 percent of their equity. It is not clear, though, whether these troubled banks can elect not to defer recognition in order to use up expiring net operating losses.

The FDIC has attempted to calculate the effectiveness of a troubled bank ratio in identifying banks on our problem list. It is not yet clear, though, what assets are to be counted as nonperforming, how equity is to be defined, and whether the 75 percent test would be applied on an individual bank or on a consolidated basis.

When computed on a consolidated basis—that is, by adding up all the nonperforming loans in each bank owned by a holding company—only 14 of the 398 organizations have a ratio over 75 percent. These 14 organizations own 60 banks, of which 31 are currently on our problem list. So the troubled bank test identified less than one-third of the 104 problem banks losing their bad debt reserves.

Moreover, all but 2 of these 14 companies reported losses in 1985 and for them, from a tax standpoint, they might be better off to recapture existing reserves now rather than later.

The ratio does somewhat better if it is computed separately for each bank in a holding company rather for the consolidated organization. On this basis, relief is granted to 51 of the 104 problem banks affiliated with large banking organizations. This approach also seems more logical because it focuses relief on the particular bank in trouble.

The ratio does better at lower levels. At 50 percent instead of 75 percent, it would grant relief to nearly two-thirds of our large problem banks.

In sum, we think taking away the bad debt reserve is a move in the wrong direction and at the wrong time. The troubled bank test does little to change that. At a minimum, we urge Congress to ensure that the test is applied on an individual bank basis and that troubled banks are not required to defer recapture.

We also urge that foreclosed real estate be counted as nonperforming assets and that ratio levels below 75 percent be considered.

I will quickly comment now on some of the other provisions. The law would generally prohibit banks from deducting the interest costs incurred to carry tax-exempt securities acquired after August 7, 1986. Since banks hold about one-third of total tax-exempt securities, the potential tax impact could be dramatic, particularly for small banks because they hold proportionately more in municipals. Most likely, bank demand for municipals will decline and, if not offset by demand from other investors, the value of current tax-exempt investments will be depressed. Banks needing to sell their municipals from liquidity or tax planning purpose would have to absorb the loss. It seems to us the current rules should follow existing securities until maturity and not change at time of sale.

The proposed tax law also creates a new alternative minimum tax to replace the present add-on minimum tax. This will most impact banks with large holdings of tax-exempt bonds which are most likely to be smaller banks. Most banks will not be affected, however. Unfortunately, banks looking to reduce their holdings of municipals may face a somewhat less receptive market for reasons mentioned above.

The proposed law would also take away special rules which allow banks to carry back losses 10 years to recoup past taxes paid. This provision would continue for several years, though, in order to soften the impact for institutions affected by current problems. Ironically, this transition rule recognizes that expected losses in a loan portfolio cannot be promptly identified—the reason we advocate the continuation of loan loss reserves.

The tax reform package will also curtail the use of foreign tax credits to offset U.S. taxes. How much is not particularly clear to the FDIC yet, but larger banks are significant participants in oversea loan markets and last year used about $1.2 billion in foreign tax credits. Much of these credits are attributable to high withholding taxes on loan interest earned imposed by countries experiencing financial strains. The proposed law would reduce the financial incentives for making foreign loans, although transitional rules should ease the impact on certain IMF countries.

Repeal of the investment tax credit will also affect banks with sizable leasing operations which has been a good growth business for many larger banks. In 1985, these companies claimed approximately $600 million in investment tax credits. These credits will most likely result in a lessening of banks' involvement in lease financing and/or higher costs to lessees.

The tax provisions relating to real estate investments may impact banks by reducing the value of the $8 billion in foreclosed real estate currently on their books. The quality of some loans secured by income-producing properties could also be reduced, particularly those to limited partnerships operating primarily as tax shelters.

Restrictions on IRA accounts will shrink an important source of deposit growth forcing banks to develop new funding sources. This likely will be most difficult for smaller institutions.

Before concluding let me emphasize that the FDIC strongly supports the objectives of the proposed tax change. Banks as well as other taxpayers should each pay a fair share of the national tax bill. What's fair is largely a matter of perception and whether or not banks pay their fair share of taxes is a matter for others to debate. However, tax legislation should consider the realities of the banking industry. The real world involves a banking industry under strain due to mounting credit problems. The reality of the credit-granting process is that losses in loans may not be identifiable for some time. The tax law should recognize this and allow banks to reserve adequately to cover anticipated losses.

In conclusion, we believe the tax law would increase U.S. income taxes paid by the banking industry, but we fully expect banks will adjust their business strategies to minimize the impact on their after-tax earnings. To the extent they are able to do this, the value of their capital—and thus their ability to raise it—will not be lessened in the marketplace.

Given the industry is facing its greatest strains in recent history, we certainly hope that will be the net effect. Thank you.

[The prepared statement of Mr. Cooke follows:]

PREPARED STATEMENT OF DAVID C. COOKE

I appreciate this opportunity to present the FDIC's views regarding the pending tax reform legislation and its likely impact on the safety and soundness of the banking system and on the federal deposit insurance system.

As a matter of policy, the FDIC does not take a position on pending tax legislation except where we feel a particular provision will have a negative effect on the soundess of the banking system. With regard to the current proposal, we have focused our attention on the one provision we feel will work to the detriment of the system -- elimination of the reserve method of accounting for bad debts. Thus, my comments include only a limited review of the other provisions of the proposal and their likely effects on the banking system.

The current tax reform proposal represents the most ambitious restructuring of the U.S. tax code ever undertaken. The effects on the operations of businesses and consumption patterns of consumers are not well defined and may not become evident for some time to come. It is clear that taxpayers will rearrange financial arrangements in response to new and different tax incentives. Banks are no exception; they will adjust to this new environment. However, as with any change in rules, adjustments can create new, and exacerbate existing, problems.

Before addressing specific provisions of the pending tax reform, I would like to provide some perspective by briefly reviewing the condition of the banking system and what we see as the likely trend within the system.

Bank Performance

Banks have been failing at rates not seen since the advent of federal deposit insurance. Over the 40-year period from 1941 to 1980, only 262 banks failed. Since 1980, over 400 banks have failed. Last year's record of 120 bank failures will soon be eclipsed as 100 banks have already failed this year, and we expect another 40 to 60 more.

While failure statistics reflect past problems in the banking industry, other measures provide a clearer view of what lies ahead. A leading indicator of bank failures is the number of problem banks. Currently, the FDIC has classified 1,418 banks as "problems." This compares to 1,140 at year-end 1985 and 848 the year before that. In fact, the number of problem banks has increased sixfold since 1981 (Table I).

Other indicators portray a similar trend. Bank earnings relative to average assets have declined noticeably in recent years. This has occurred despite an increase in capital levels, which should have a positive effect on bank return on assets.

Bank earnings are also much more volatile. Once, almost all banks operated profitably -- save for new banks just starting out. Today, many banks, including many established banks, are in the red. In 1980, less than four percent of all insured commercial banks finished with negative earnings. That percentage has steadily increased -- rising to 11 percent in 1983, 14 percent in 1984, and over 16 percent last year.

There are significant differences between the performance of small versus large banks. Over 25 percent of commercial banks with under $25 million in total assets lost money last year. The return on average assets for banks in that size category was less than 40 percent of what it was for all other commercial banks. Until a few years ago, smaller banks consistently outperformed their large competitors.

Although the levels of nonperforming loans within the industry have moderated somewhat over the past two years, they remain high. This is despite rising net charge-off rates, which have more than doubled over the past five years, and are ten times what they were 30 to 40 years ago. The prospects for major declines in nonperforming and charge-off levels do not appear very bright, at least not in the short run.

Looking at charge-offs by loan type indicates that bank asset problems are not confined to just one or two categories. Net charge-off rates for real estate loans have more than doubled since year-end 1982. The same is true for commercial and industrial loans. In 1985 alone, net charge-off rates for farm and consumer loans jumped by over 50 percent from the year before.

Tax Reform Provisions Affecting Banks

While there are several provisions that affect banks directly, any provision that alters consumer or business decisions indirectly has an influence on banks. These "indirect" effects may influence a bank's sources and costs of funding, the types of investments it chooses, and the quality or asset value of existing credits.

The direction and magnitude of many of these effects currently are not well understood. Some may prove to be relatively insignificant from a safety and soundness point of view. Only time will tell. At this point, I would like to review those provisions directly affecting banks and those "indirect" effects that are perceived to present some concerns.

Tax Rates

The current top corporate tax rate is 46 percent. This would be changed to 34 percent and is the only aspect of tax reform which would be directly favorable to banks. The tax savings to banks from lower tax rates are difficult to estimate since

tax-induced changes in bank portfolios would likely cause a considerable change in banks' taxable income. Ignoring these other effects, we estimate the lower rate would reduce banks' annual U.S. income tax liability about $1 billion.

Bad Debt Reserves

No provision of the proposed tax law troubles the FDIC as much as the elimination of loan loss reserves for large banks. Current tax law allows all banks to maintain reserves computed under either the percentage method or the experience method. The percentage method allows reserves to be maintained at 0.6 percent of eligible loans. This percent was ratcheted down from 2.4 percent under the Tax Reform Act of 1969. Back then, loan losses were running well below 2.4 percent and the intent was to phase banks into the experience method. Now though, loss rates have more than doubled and are significantly above 0.6 percent. This phenomenon has caused many banks to "voluntarily" switch to the experience method which effectively allows reserves to be based on a six-year moving average of loss rates.

Under the proposed law, banking organizations with total assets of $500 million or more would no longer be allowed deductions for bad debt reserves. Losses in their portfolios could only be recognized when specific loans have been identified and charged off. Moreover, these organizations would have to recapture (something the Tax Reform Act of 1969 did not require) existing reserves over four years unless they qualify as a troubled organization.

The FDIC, from the beginning, has opposed this tax change. We do not object to banks paying their fair share of taxes, but we feel strongly that providing for bad debt reserves is good accounting, good business and good banking. In our view, anything that discourages banks from providing for losses in their loan portfolio is potentially dangerous. Last year, net loan charge-offs amounted to $13.1 billion or 0.80 percent of year-end loans. We have not seen a rate that high since 1936. Table II compares the loan charge-off ratio over the last five decades. The ratio is over ten times what it was in the forties and fifties and nearly double what it was in the seventies. We and other regulators are continually encouraging banks to reevaluate their loan portfolios and adequately provide for potential losses. Table III indicates that banks have been increasing their reserves while their losses also have increased. The level of nonperforming, subquality assets continues to outpace the growth in reserves. The change in the tax law will certainly not help in the effort to get banks to increase their reserves.

The elimination of the bad debt reserve deduction for large banks not only has adverse safety and soundness implications, it represents the loss of a reasonable and legitimate business expense. It is simply a fact that loan losses occur before they are identified. If it were otherwise, we would probably have a lot fewer bank failures -- banks would know to avoid certain credits before it becomes too late. Moreover, we see no reason for the arbitrary distinction between large and small banks. Bad debt reserves are just as appropriate for a $550 million bank as they are for a $450 million bank.

Currently, there are 525 banks with over $500 million in assets. However, the proposed law takes away deductible bad debt reserves from banking organizations with consolidated assets over $500 million. Nearly 2,600 banks are affiliated with larger bank holding companies and would lose their bad debt reserves. As a group, 398 banking organizations, with $2.3 trillion in assets and about 80 percent of the loans in the banking industry would be affected.

These banks will have to recapture existing bad debt reserves over the next four years. We do not know the volume of these reserves that will be subject to recapture. However, in light of the effective minimum of 0.6 percent of qualifying loans and recognizing that many banks have switched to the experience method, we have assumed that the number is between $7 and $12 billion. Using a 34 percent tax rate, this provision would cost the industry between $2.4 and $4 billion.

The tax law would allow certain "troubled" banking organizations to defer recapture of their loan loss reserves. Such organizations are those whose nonperforming assets exceed 75 percent of their equity. At this point though, it is not clear what assets are to be counted as nonperforming, how equity is to be defined and whether the 75 percent test would be applied on an individual bank or on a consolidated basis. It is also not clear whether or not a "troubled" bank can elect not to defer recognition in order to use up expiring Net Operating Losses.

The FDIC has attempted to calculate the effectiveness of this ratio in identifying problem banks. We assumed nonperforming assets include only loans 90 days or more past due and nonaccrual loans. Not counted as troubled assets was foreclosed real estate, though we believe it should be. We also assumed that capital referred to total book equity and did not exclude intangibles such as goodwill.

Of the 398 affected organizations, only 14 organizations have a ratio over 75 percent. These 14 banking organizations represent 60 banks of which 31 are currently on the FDIC's problem bank list. Of all the banks affected by the tax change, 104 are on our problem list; so the troubled bank test identified less than one-third of problem banks losing their bad debt reserves.

When computed on a consolidated basis, the troubled bank ratio grants relief too late and where it is least needed. All but two of these 14 companies reported losses in 1985 and, for them, the tax effect of recapture is probably a moot issue. These companies may actually be better off from a tax standpoint to recapture reserves now rather than later.

The test does somewhat better if applied on an individual bank basis, i.e., if the ratio is computed separately for each bank in the holding company rather than for the consolidated organization. On this basis, relief is granted to 51 of the 104 problem banks affiliated with large banking organizations. Moreover, resources of nontroubled banks cannot be used to save a troubled affiliate. Capital is regulated on an individual bank basis. Also, the Federal Reserve Act prohibits banks from acquiring low quality assets from affiliates. Therefore, it seems more logical to apply relief based on the condition of the individual banks rather than the consolidated organization.

The ratio also does better at lower levels. At 50 percent instead of 75 percent, the ratio would grant relief to nearly two-thirds of our large problem banks -- if applied on an individual bank basis. At that level, only eight percent of all large banks would qualify as troubled.

In sum, we think taking away the bad debt reserve is a move in the wrong direction and that the troubled bank test does little to change that. At a minimum, we urge Congress to ensure that the test is applied on an individual bank basis, and that "troubled" banks are given the option to recapture reserves. We also think 75 percent is too high a threshold (50 percent would be more realistic) and that foreclosed real estate should be counted as nonperforming assets.

Interest to Carry Tax-Exempt Securities

In general, banks will not be permitted to deduct interest expense incurred to carry tax-exempt securities acquired after August 7, 1986. Since banks historically have been one of the most significant holders of tax-exempt securities (currently holding approximately $140 billion or about one-third of total tax-exempt issues), yields on these issues are likely to increase. We already have observed an increase in the yield of tax-exempts, most likely in part because of this provision.

This provision may depress the value of tax-exempts currently held in bank portfolios. Interest deductibility would continue for these securities while held as investments, but sales would be at market prices reflecting the new tax rules. Banks needing to sell their municipals for liquidity or tax planning purposes would have to absorb the loss.

This provision, coupled with the corporate minimum tax (discussed below), will impact small banks disproportionately. Small banks have invested relatively more in tax-exempt securities than have larger institutions. For example, banks with less than $100 million in assets hold about 30 percent of all municipals but less than 20 percent of industry assets. A more equitable solution, it seems to us, would be to allow the current rules to follow existing securities until maturity or for a specified number of years. We suspect this would have minimal impact on taxes since most banks would otherwise hold the securities until maturity. It's the few banks that would need to liquidate that we're concerned about.

Corporate Minimum Tax

The proposed tax law also repeals the present add on minimum tax and creates a new alternative minimum tax (AMT). After 1989, banks will have to compute their AMT based on their earnings and profits. We are not aware of the final rules that will govern this calculation and thus are unable to assess the likely impact on the banking industry. Until 1989, the transition rules will essentially require banks to recompute their taxes based on 20 percent of the sum of taxable income plus one-half of tax preference items. Banks will be liable for the greater of this AMT or normal computed taxes. The largest tax preference item is income on tax-exempt bonds. Banks with a large proportion of tax-exempt income -- on the order of 60 percent or more of accounting income -- will be subject to the minimum tax. Most banks will not be affected although, again, smaller banks hold a larger portion of municipal securities. A number of smaller institutions undoubtedly will have to pay more taxes. Moreover, this impact will be exacerbated by the proposed change regarding the deductibility of costs of carrying municipal securities. Unfortunately, banks looking to reduce their holdings of municipals would face a somewhat less receptive market to the loss of interest deductibility described above.

Net Operating Losses

The effect of subjecting banks to the same rules as other taxpayers (carryback three years; carryforward 15 years) will be to force banks to rely more on future tax liabilities to recapture current losses. Under existing laws, banks operating in a loss position can realize immediate tax benefits (cash refunds) until taxes paid over the immediately preceding ten years have been recaptured.

Receiving immediate tax benefits in response to a loss is of significant importance to a bank and, in some cases, can mean the difference between solvency and insolvency. The tax committees recognized this and, in light of the current economic climate affecting many institutions, adopted transitional rules that would allow the ten-year carryback provision to remain for losses attributable to bad debt losses in tax years beginning before 1994. This will soften the impact of tax reform for institutions affected by current problems. Perhaps unintendedly, it also recognizes that expected losses in a loan portfolio cannot be promptly identified -- the reason we advocate the continuation of loan loss reserves.

Investment Tax Credit

Repeal of the investment tax credit will primarily affect banks with sizable leasing operations. Direct lease financing has been one of the fastest growing areas in banks' portfolios, with the industry currently having an investment in excess of $24 billion in this activity. One of the attractions of lease financing is the tax benefits that accrue to the banks due to purchases of assets eligible for the credit. In 1985, banking companies claimed approximately $600 million in such credits. For the most part, these credits have been taken by larger banking organizations. Smaller institutions will be relatively unaffected.

Repeal of this credit most likely will result in increases in leasing costs to lessees and a diminution of banks' involvement in lease financing.

Foreign Tax Credit

The operation of the foreign tax credit and the effect the tax reform package will have on credits available to banks is complex and the impact is not yet clear to the FDIC. A number of the larger U.S. banks are significant participants in overseas loan markets, with total foreign loans currently at about $300 billion. These institutions used about $1.2 billion in foreign tax credits to reduce their U.S. tax liability. The proposed tax law will curtail the use of such credits. Essentially, banks will no longer be able to average credits from high and low withholding countries where the country's withholding taxes on interest earned are five percent or more. The proposed limitations will reduce the relative attractiveness of foreign loans. Presumably, banks will demand a higher yield or seek alternative investments.

In an effort not to discourage lending by U.S. banks, the proposed law provides for a five-year transition for 34 International Monetary Fund countries. The identity of these countries has not been made public, although presumably they include the 15 countries covered by Secretary of the Treasury Baker's plan to aid less developed countries. Loans to these countries account for about one-third of all loans to foreign countries.

Other Provisions

As stated earlier, virtually every provision of the tax reform legislation will have some effect on bank operations. Some are more obvious than others. The provisions relating to real estate investments (longer depreciation schedules and restrictions against offsetting losses against earned income) may reduce the value of foreclosed real estate currently held by banks. At the present time, banks hold about $8 billion in foreclosed real estate, about double what it was four years ago. These provisions could also reduce the quality of some loans secured by income producing properties. We are particularly concerned about loans to limited partnerships operating primarily as tax shelters.

The restrictions on eligibility to make tax-deferred contributions to an IRA will also affect banks. These accounts have grown in importance in terms of funding sources, and currently banks hold about $52 billion, or 26 percent, of all IRA deposits. The new rules will diminish the importance of IRAs for banking institutions. Banks will have to develop new products to fund growth. This transition may likely be more difficult for smaller institutions.

Conclusion

The FDIC strongly supports the objectives of the proposed tax change. There is no disagreement that banks, as well as other taxpayers, should each pay a fair share of the national tax bill. What's fair is largely a matter of perception and clearly banks suffer from the perception that they pay less than their fair share of taxes. The banking industry has argued, at various times, that federal income taxation should not be viewed in isolation, and that other implicit taxes, such as the cost of keeping noninterest bearing reserves with the Federal Reserve System and the lower yield earned on tax-exempt bonds, should be considered. My purpose today is not to support either side in this controversy. However, tax legislation cannot be evaluated without considering the incentives provided by the revised structure and the realities of the "real world."

In the case of banking, the real world involves a significant number of banks adversely affected by problem sectors: energy, agriculture, international obligations and, in some cases, commercial real estate. In this situation, the incentives, tax and otherwise, should be for banks to reserve adequately to cover anticipated losses so as not to present an overvalued balance sheet. The tax reform proposal does not accommodate this; in fact, the incentive is to provide minimal reserves, and realize losses only when specific loss items can be identified. Not only does this provide the wrong incentives, it does not correspond to the realities of the credit granting process.

With our limited knowledge of the details of other tax revisions, it is difficult to assess fully the impact on banks. On balance, U.S. income taxes will most likely increase for the banking industry, but we fully expect banks will adjust their business strategy to minimize the impact on their after-tax earnings and their capital. To the extent banks are unable to preserve after-tax earnings, the value of their capital -- and thus their ability to raise it -- will be lessened in the marketplace. In this regard, capital markets have consistently assigned less value to the earnings of banks than that given other industries. Should the markets perceive the proposed tax law affects banks worse than other industries, raising capital will become even more difficult. This effect would come at a time when the industry is facing its greatest strains in recent history.

TABLE I

Problem and Failed Banks

	Failed Banks*	Problem Banks (Period-end)
1986 (Aug.)	100	1,418
1985	120	1,140
1984	80	848
1983	48	642
1982	42	369
1981	10	223

*Includes assistance transactions

TABLE II

Historical Net Loan Charge-off Ratios

	Ratio
1934	3.421
1935	1.610
1936	0.875
1937	0.309
1938	0.585
1939	0.419
1940-44	0.072
1945-49	0.058
1950-54	0.063
1955-59	0.068
1960-64	0.146
1965-69	0.171
1970-74	0.304
1975-79	0.473
1980-84	0.520
1985	0.804
1986*	0.826

*First Half

TABLE III

Net Loan Losses, Nonperforming Assets and Book Bad Debt Reserves ($ - Billions)

	Nonperforming Assets #	Book Loan Loss Reserves	Reserves to Non-performing Assets	Net Loan Losses
1986*	$ 56.6	$ 26.2	46.3%	$ 7.0
1985	51.0	23.1	45.3	13.1
1984	49.5	18.6	37.6	10.7
1983	46.0	15.4	33.5	8.4
1982	45.3	13.2	29.1	6.6
1981	NA	11.4	----	3.8

*First Half

#Includes loans 90 days or more past due or on nonaccrual status and foreclosed real estate.

Representative OBEY. Thank you, and thank you all. Let me start with you, Mr. Cooke. You indicate that you think banks will adjust their strategies in order to try to deal with this new bill. What does that mean in terms of banks with a significant number of farm loans? Would you be suggesting, for instance, that this would make it much more significant and difficult for financial institutions to avoid foreclosing on shaky farm loans?

Mr. COOKE. With regard to the elimination of the bad debt reserve, there's a couple schools of thought, one is that since banks will only be able to recognize a loss for tax purposes when they've charged off a specific loan that some banks might move more quickly on foreclosing on particular farm loans.

The other school of thought is the banks will primarily continue to foreclose when they think it makes the most economic sense.

We do not know exactly which way it is going to work out. Only time will tell. By adjusting to the new tax changes primarily we were focusing on how we suspect banks will shift out of municipals or shift out of leasing operations or demand higher returns, and they will be a little more reluctant, we would think, to make loans to foreign countries.

Representative OBEY. You said that you have not seen a rate for net loan chargeoffs which you said amounted to $13 billion of year-end loans—you have not seen a rate like that since 1936?

Mr. COOKE. That's correct. It has been going up steadily.

Representative OBEY. In other words, 10 times what it was in the 1940's and 1950's and double what it was in the 1970's?

Mr. COOKE. Yes, sir.

Representative OBEY. Let me ask the other panelists, in light of those numbers and Mr. Cooke's comment, would any of you have any observations on the effect of this bill on the banking system? Mr. Eisner.

Mr. EISNER. Well, with some hesitancy because I really don't know the details of the banking system, but one thing that just struck me, Mr. Cooke remarked on the places that banks would reduce their loans. That means they would be increasing them somewhere else and there would be other beneficiaries.

I guess, in general, I am unsympathetic to deductibility of reserves for losses that may take place in the future. It seems to me that losses should be deducted on a current basis and I don't approve of any of this business of making believe you're going to have some burden in the future, even assuming you will have it in the future, and charging it now. That is, at best, a free loan from the Government of tax revenues.

Representative OBEY. Does anybody else want to comment?

Mr. COOKE. I would just like to respond to that. I think that just does show lack of familiarity with the banking industry and how the loan process works.

Loan losses—right now there are any number of banks—well, probably every bank has loans that it still has not specifically identified but it knows by the way the economy has been moving, by what's happening with particular borrowers, by the trends in its community, that it's about to suffer losses. If it has to wait until they finally all do go bad, it's probably too late. It's much more appropriate that they make an estimate on how much loss they think is in their portfolio today and then adjust it later if they find out they have overestimated or underestimated it.

Representative OBEY. I can't help but observe that that is even true for the Eximbank, which still carries on its books as a potentially good loan, loans to Cuba. I don't think anybody expects Cuba is going to be repaying loans to the Eximbank in the next couple years.

On revenues, if I can just run down the table and ask you to point thumbs up/thumbs down to save time for other questions, is there anybody here who—at least three of you have already indicated what you think—is there anybody here who thinks that this bill is likely not to result in a larger deficit than we would be led to believe by the official estimates?

Mr. BRINNER. I indicated that I thought that revenues would be lower, but that, on average over the 5 years, expenditures would be lower by a comparable magnitude. So that from a deficit point of view, this was not a problem.

Representative OBEY. How about next year? The reason I'm focusing on next year is not necessarily because it's the most important to the economy, but because next year is the year when Gramm-Rudman could go "bang."

Mr. BRINNER. Next year, our estimate—and this is on a calendar basis but the fiscal year would be similar—is that the total taxes would be reduced by $25 billion, expenditures by only $7 billion, giving you an $18 billion difference in the deficit. So that has to be made up in future years with bigger interest savings and then the bill turning into a revenue gainer of major proportions on the corporate side.

Representative ARCHER. Would the chairman yield for just a quick question on that? Since the bill provides for an $11 billion revenue increase in 1987, you are basically saying there's going to be a shortfall of $36 billion, is that correct?

Mr. BRINNER. I'm sorry. When he said next year, I was thinking you were talking about the year after the one you're currently considering. For 1987, a $7 billion difference in the deficit; and 1988 an $18 billion difference in the deficit.

Representative OBEY. 1988 is $18?

Mr. BRINNER. 1988 is the $18. That's where you have the big problem because the bill on a static basis is intended to raise $11 billion in 1987 and then lose $17 in 1988.

Representative OBEY. I caused the confusion because when I referred to next year I meant the next year, not 1987 but 1988.

Mr. BRINNER. And it is 1988 where you get the big problem because you have the big revenue loss from the personal cut being fully phased in. I would ask you to vote in favor of the tax reform bill but making a commitment at the same time to do something like greater deficit reduction at the same time.

Representative OBEY. Of course, that's the problem with the budget process and that's the problem with Gramm-Rudman. We always get over this year's problem by delaying those problems until next year.

Mr. BRINNER. I would ask that you not use the extra revenue this year, be consistent on that. I would agree. Don't postpone your problems until next year. Don't use that static revenue gain to help make up the $19 billion optimistically estimated shortfall.

Representative **Obey**. Let me ask, Mr. Summers, you indicated in your prepared statement that you thought we ought to look at restoring the investment tax credit, but you say:

> If in the future tax breaks for specific industries are considered on an ad hoc basis it will be difficult to protect the accomplishment represented by the conference committee bill. For the next several years Congress should strongly resist efforts to reopen debate over tax details.

Are you saying—to put that together with your observation on the investment tax credit, do you think stability is important enough that even though in your judgment the elimination of the ITC is a mistake that we still ought to accept that elimination?

Mr. **Summers**. I would distinguish between microeconomic policies and macroeconomic policies. I had in mind, in the reference you quoted, provisions affecting specific industries—banks, timber, oil and gas—rather than provisions that I thought of as being macroeconomic in their impact, like the investment tax credit which affects firms across a very wide spectrum.

I would not value stability to the point where you would use it as an argument against reinstituting the ITC.

Mr. **Brinner**. Well, I might argue that discussions with some of our industrial clients suggest that the mere mention of the possibility that the ITC could be reinstituted in 1988 or some other year will intensify the sluggishness of capital spending until it's reinstituted. If they believe that there's going to be a 10 percent credit initiated for 1988, that will create an even bigger hole for the economy in 1987.

So I would include the investment tax credit as something that is an unfortunate victim but we don't want to talk about bringing it back because that will create large problems.

Representative **Obey**. Well, here's my concern as a legislator. You indicated that we ought to give this an A for equity, a B for growth, and a C for simplicity. My observations in my own district are that we do not certainly yet have the public feeling that this is going to be an increase in equity. They may come to feel that, but I get a profound sense of skepticism expressed by my people. And I'm not talking about my bankers and my manufacturers. I'm not talking about the CEO's of companies in my district. I'm talking about the people I run into as I walk down Main Street, in hardware stores, in taverns, in grocery stores, you name it, just talking.

If the main selling point for this bill is equity, but if people get the impression that that equity is going to last about as long as the calendar is this year and then we're going to be jumping back in for a lot of other changes, I'm wondering whether we're ever going to get the public to conclude that this bill is an entree to equity in the first place.

I am very reluctant to vote for this bill. I come from an area that has a lot of old-line industries. I'm very reluctant to vote for this bill. At the same time, if I vote for it, I'm terribly afraid I'm going to have to go back in the soup supporting a lot of changes next year, because the one thing people do want is stability.

Mr. **Jasinowski**. Mr. Chairman, I would say on the stability question that from the point of view of most industry leaders that, notwithstanding our feeling that the investment tax credit is a mistake, that there's really not much enthusiasm for going back in for a lot of changes to the code quickly, that stability has as much to do with investment decisionmaking, perhaps more, than incentives do.

So I think you're going to get this back and forth and we're going to be into it, but I don't sense within the industrial community a desire to push for additional tax changes. Now if it comes from the Congress or if it comes from other places, that may occur. But certainly, business would prefer some stability for the next 2 or 3 years.

Representative OBEY. Well, to me, the only reasonable rationale for going into this thing—again, if we decide to pass it—if you eat a turkey, at least you ought to digest it first it seems to me—and the only way that I would feel comfortable adjusting it after we had gone through all of this strain is if the revenue estimates proved to be horrendously off because given the requirements of Gramm-Rudman-Hollings we can't let that happen without screwing up everything else on the block. I've exceeded my time. Congressman Archer.

Representative ARCHER. Mr. Chairman, you will never exceed your time.

Respresentative OBEY. Well, I do when we have to finish it.

Representative ARCHER. I feel very much the same as you do and I want to ask a number of questions.

First, I want to follow up on your line of questioning with Mr. Brinner and that is to be sure I understand what you're saying.

In 1987, what do you think the revenue will be? We know that the estimators say it's going to be $11 billion plus. As I understood you, you said it would be minus $7 billion. So are you saying it's going to be $18 billion less than the estimators?

Mr. BRINNER. No. I said the deficit in 1987 would be $7 billion difference. That would be taxes down $10 billion and expenditures down $3.

Representative ARCHER. Okay. But just from the standpoint of the tax bill, one of the things that disturbs me, quite frankly, in listening to all of you, is that you cannot assume that there is going to be fiscal responsibility in the Congress. You cannot assume that the Federal Reserve is going to do anything in one direction or another. You've got to look strictly at this tax bill and talk just about this tax bill and not say to us, "Hey, but if you do this over here, then everything is going to be different." Our deal is strictly the tax bill.

Mr. BRINNER. In our forecast, we assume not that Congress is irresponsible, just that there are so many political pressures, that you can't hit Gramm-Rudman. Our forecast is that for 1991, instead of hitting a balanced budget, you get to something like a $120 billion deficit.

Representative ARCHER. All right. But continuously woven into all your testimony today was that, "Well, we really can do this if we do a certain thing with the money supply. We really can do this if we get our fiscal budget in a different posture or whatever." But I think we have to talk today just about the tax bill and not take into account any of these other variables because then you get into complexities beyond the capability of any of us to understand as we deal with the tax bill.

So let me see if I understand you for 1987. What do you predict the revenue estimates from this tax bill will be in 1987?

Mr. BRINNER. I would agree with the committee estimates.

Representative ARCHER. You think it will be $11 billion above the current law?

Mr. BRINNER. The static estimates I'm taking as given. Because the economy is somewhat weaker, I estimate the tax receipts will be lower by $10 billion.

Representative ARCHER. Even under the current law?

Mr. BRINNER. That's right.

Representative ARCHER. But you don't think this bill will impact, other than what the estimators say, $11 billion plus compared to the current law?

Mr. BRINNER. I agree that they've done a good job of trying to estimate some behavioral responses. But what they haven't taken into account is the fact that the economy will turn sluggish in the first year and that means that instead of gaining revenues, as you would on a static basis, you lose revenues.

Now the way Gramm-Rudman is written, you are not allowed to take into account those feedback effects. So even though I predict those losses will occur, they won't be counted against you in a Gramm-Rudman kind of thing.

Representative ARCHER. So you say basically, according to your expectations, as I understand what you just said, that basically we will have in 1987 what we would anticipate today if the estimates were correct under the current law?

Mr. BRINNER. You would have a deficit of around $175 billion rather than the hoped-for——

Representative ARCHER. I'm not talking about the spending side. I'm talking about just the tax.

Mr. BRINNER. I estimate that you will lose $10 billion because of the weak economy.

Representative ARCHER. But you're going to pick up $11 billion under this new bill and it will be a wash compared to the current law, is that right?

Mr. BRINNER. You pick up $11 and lose $21, so you're down $10.

Representative ARCHER. OK; that's what I'm trying to get at. So really we're going to have, according to your projection, a $10 billion negative impact in 1987 compared to the estimators' $11 billion plus?

Mr. BRINNER. That's correct.

Representative ARCHER. So we are $21 billion short compared to the current law.

Mr. BRINNER. And the only benefit that would give you is because interest rates will be lower you will save $3 billion on interest expenses, so you're $18 off on the deficit.

Representative ARCHER. And interest rates will be lowered just as a result of this bill and not anything else?

Mr. BRINNER. There's a small additional factor in 1987 from Federal Reserve support, but I think——

Representative ARCHER. Well, let's take that out. The Fed may decide to support that irrespective of whether this tax bill passes.

Mr. **Brinner**. If you take that out, then it's an even bigger problem.

Mr. **Eisner**. May I say something. I would just like to understand Mr. Brinner, too. Are you saying that because of the tax law the deficit will be $20 billion more?

Mr. **Brinner**. The deficit in an economy with the tax reform bill—let's talk to revenues—the revenues will be $10 billion lower in spite of a static $11 billion increase.

Mr. **Eisner**. Because of the tax law or because of the economy?

Mr. **Brinner**. Because of the tax law's effect on the economy.

Mr. **Eisner**. That, of course, I would question, although Mr. Brinner has his model and he plays with it. To the extent I've looked at his model and other model, I think what that must be building in is a huge impact on investment incentives, reduction in investment, which I don't think we have any reason to believe.

Representative **Archer**. Well, I understand all of you are going to disagree about the impact of the bill, but I wanted to pursue this with Mr. Brinner if I could, and then you are free to say you disagree with me. But if I might just go on and pursue this.

So if we are $21 billion short of revenue compared to what the estimators say, $10 billion net short, then we have—and I can guarantee you this Congress is going to reach out and embrace this $11 billion with open arms because it makes their job so much easier. They are not going to bank it and save it. They are going to take it.

Mr. **Brinner**. Even though it means that they have a much more difficult problem for 1988.

Representative **Archer**. Of course, of course. You talk to a majority of my colleagues. A long-term problem is that which lies between now and the next election, and we have an election coming up.

You know, let's face the reality. As Mr. Cooke said, you know, you got to understand the banking industry to understand what is going to happen. You got to understand the Congress to understand what is going to happen here. They are going to fold this in, and they are going to be so happy, and they can go home and tell their constituents they met the Gramm-Rudman targets.

You know, I can virtually guarantee you, and I think Dave would agree with this.

Mr. **Brinner**. I have read different comments from others.

Representative **Archer**. Okay. But in any event, that is my judgment.

Okay, so we go in anticipating $11 billion more, we end up with $10 billion less. We are $21 billion short going into 1988.

Mr. **Brinner**. That is right.

Representative **Archer**. Then on top of that your estimates show a $25 billion shortfall in 1988. Did I understand your response?

Mr. **Brinner**. That is correct.

Representative **Archer**. So that is 25. That is 46. We have to meet a target of a minimum of $36 billion under the current law. This is a total of $82 billion that the Congress is going to have to come up with 1 year from now in savings?

Mr. **Brinner**. I don't assume you make that. I assume you do not.

Representative ARCHER. No, I am not asking you what you assume. I am just trying to present for the public to understand the magnitude of what is involved in this tax bill as it impacts on the budget deficits and Gramm-Rudman.

Mr. BRINNER. I wouldn't even recommend that you try to hit Gramm-Rudman. If you did and made expenditure cuts of the size you just calculated, you would create a recession. No doubt about it.

Representative ARCHER. Well, yes, I appreciate that input. But what this says to me is that if this tax bill passes we can kiss Gramm-Rudman goodbye, and that is what I interpret you are saying. Is that correct?

Mr. BRINNER. For 1988?

Representative ARCHER. You said we won't make it.

Mr. BRINNER. It will have to be massively amended to change the schedule. You are going to have to raise your——

Representative ARCHER. Well, that means we can kiss Gramm-Rudman goodbye as we know it today.

Mr. BRINNER. I hope you don't kiss it goodbye forever.

Representative ARCHER. Does anybody disagree with this on the panel, that this places the seeds of the destruction of Gramm-Rudman and being able to even have any hope of getting to a balanced budget in 1991?

Mr. EISNER. I disagree. I would say the seeds of the destruction of Gramm-Rudman were set the day you passed it, and it is dead. You are not going to be able to meet its targets and it is good that you won't be able to meet them. You would wreck the economy if you did.

Representative ARCHER. OK; well, that is another issue, but do you think this——

Representative OBEY. Is that all? [Laughter.]

Representative ARCHER. Do you think this bill puts us in a better chance to reduce deficits or that it will increase deficits?

Mr. EISNER. I don't know positively, and that is what I wanted to make clear with regard to what Mr. Brinner was saying. I don't think he disagrees with me.

Understand that he is not disagreeing with the revenue estimates, the static revenue estimates. He is saying that in his opinion the tax bill is going to hurt the economy, reduce income, and therefore, reduce tax revenues.

Now, you may or may not agree with that, but understand that if you are concerned with what he is saying it is because you believe that the tax bill will lower national income, and therefore, tax revenues. That is what his statement depends on, not a disagreement with the Congressional Budget Office or any of the estimates which are static estimates, assuming the economy is not affected by the bill.

Representative ARCHER. Well, Mr. Eisner, that is just not true because I have worked hand in glove with the estimators as this bill has developed, and they are not using a static basis for these estimates.

Mr. EISNER. No, they are in the sense that they are assuming that it is not having any impact, up or down, on the economy as a whole.

Representative ARCHER. No, they are assuming behavioral changes. They are assuming some behavioral changes, which is not static.

Mr. SUMMERS. Congressman.

Representative ARCHER. Yes.

Mr. SUMMERS. If I might try to clarify the sense in which both my colleagues on the panel are right.

The estimates do assume behavioral changes in the way people time their income, in the pattern of where they invest, and so forth. So at the microeconomic level—they give less to charity and so forth—at the microeconomic level there are a host of behavioral changes that are assumed, and they are dynamic.

At the macroeconomic level it is assumed that despite those microeconomic changes, the total GNP is the same with or without the tax bill and that constraint is imposed on the estimation.

Representative ARCHER. Yes, sure.

Mr. SUMMERS. When Bob Eisner speaks of the estimates as being static, that is what he is referring to.

Representative ARCHER. But the micro changes have a direct impact on revenues.

Mr. SUMMERS. Absolutely.

Representative ARCHER. And that is the point I am trying to make.

Let me ask you just this, and, Mr. Chairman, gosh, this is such a complex bill, as Alan Greenspan started out testifying. There are thousands of things we can talk about, and I hate to lose you because you are great resources and we want to make the right decision on this bill, what is right for this country—and not just for this election but what is right for this country, and your testimony has helped me a lot.

But I am concerned about a number of things that are unanswered questions.

Representative OBEY. You have got time for one more.

Representative ARCHER. All right.

What is the total cost on what has loosely been called business by many of those who talk about this bill, but really is individual to corporation, not from individual to business? What is the total cost, in your estimation, to business when you count individual proprietorships and partnerships which generate investment in this country—it is not just corporations—and I assume you have taken that into account in your determination of your feelings about this bill. But what would each of you guess is the real transfer from individuals to business?

Mr. JASINOWSKI. Well, let me take a first shot at that and tie it back into what I have been anxious to make a further——

Representative ARCHER. Because, by the way, the estimator can't break that out for me.

Mr. JASINOWSKI. Right.

Representative ARCHER. Or they won't break it out.

Mr. JASINOWSKI. I want to bring that back to the international competitiveness question, and it leads to the challenge of Bob Eisner's view that it won't make any difference what you do in this bill in terms of how well we compete.

If you were to simply eliminate the inefficient subsidies, on the one hand, in business and transfer it within the business sector and do away with these differences among businesses, you really would, I think, not harm international competitiveness.

And beyond that, as I said in my testimony, there are major efficiency gains here because you are doing away with shelters. But overall, Congressman, you are transferring roughly $120 billion of increased taxes onto the capital sector and the business sector, some of which is inefficient, much of which is efficient, and you are taking that and moving it over to subsidize additional consumption, and it is that second step which Alan Greenspan also alluded to, which is why this bill is so harmful to international competitiveness.

So one measure of the cost is $120 billion in terms of business cost. Now, let's subtract something from that for inefficient subsidies. Maybe you want to use passive investment, maybe you want to use some other provision. But let's assume it is $20 to $30 billion. You are still talking about $100 billion.

Now, another measure you could use in the econometric simulations of the increased cost of capital, which run in the neighborhood of 10 to 15 percent.

So those are two measures of the cost, but I would say without quantifying it, the real cost of this bill is because there is not a distinction between the additional taxes on capital and the shift of that to consumption.

Mr. SUMMERS. Congressman, I understood your question to be not about the total economic effect but just the revenue hit.

As a rough guess—but it is very rough because we all work from the same publications of the revenue estimators that you work from, and we get less information from them than you do, not more—but as a rough guess, corporate investment in equipment and structures is about 80 percent of all investment in equipment and structures, and so I would up the estimate roughly 25 percent.

That is excluding the residential. That is nonresidential plant and equipment. If you are counting building housing as partnerships, then you would up it by more than 25 percent.

Representative OBEY. OK; let me thank all of you for coming. I appreciate it. I know you have to catch a plane.

It seems to me what you are saying is that if we want the equity—which Mr. Summers indicates this bill gives us an A on—it seems virtually everybody is saying that if that is the case, then we are going to have to accept the consequences. To achieve that equity through passage of this legislation we will have to accept the fact that the deficit may be likely to rise, probably will be likely to rise, and that that can very well have the effect of making Gramm-Rudman go boom. That is really the choice that the Congress has to face up to and be aware of.

Thank you all very much. Appreciate it, and I hope, Mr. Cooke, that your concerns about the banking industry prove not to be as serious as they may. Thank you all.

[Whereupon, at 12 noon, the committee adjourned, subject to the call of the Chair.]

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